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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-560

BLYTH, EASTMAN DILLON & CO., INC.
and MICHAEL STOTT,

Petitioners,

v.

DAVID E. ROLF,

Respondent,

and

AKIYOSHI YAMADA,

Defendant.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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DAVID E. ROLF,
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AKIYOSHI YAMADA,
Defendant.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners, Blyth Eastman Dillon & Co. Incorporated ("BEDCO") and Michael Stott ("Stott"), respectfully pray that this Court grant a writ of certiorari to review the opinion and judgment of the Court of Appeals for the Second Circuit entered on January 3, 1978, as amended by order dated May 22, 1978. That decision affirmed the district court's judgment in favor of the plaintiff on the issue

of liability, and reversed that judgment on the question of the appropriate damage standard to be applied.

Petitioners do not in this application seek a writ of certiorari to review the ruling of the court below on the issue of damage.

Petitioners seek the issuance of a writ of certiorari only to review the ruling of the court below on defendants' cross appeal on the issue of liability.

Opinions Below

The opinion of the Court of Appeals (Appendix, hereinafter "App.", A), is dated January 3, 1978 and reported at 570 F.2d 38. After application was made for a rehearing in banc, that opinion was amended by an order filed May 22, 1978 (App. B); this addition to the opinion is not contained in the published decision (570 F.2d 38).* Rehearing in banc was denied with four dissenting votes, on July 3, 1978. The opinion of the United States District Court for the Southern District of New York (App. C) is reported at 424 F. Supp. 1021.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit was entered on January 3, 1978 (Smith, Senior Circuit Judge, and Oakes, Circuit Judge, with dissent by Mansfield, Circuit Judge). On February 13, 1978, the Second Circuit filed orders granting leave for the following to file papers *amicus curiae* in support of petitioners' petition

* The amendment is reported at CCH Fed. Sec. L. Rep. ¶96,525 (2d Cir. 1978).

for rehearing: New York Stock Exchange; Securities Industry Association; Merrill Lynch, Pierce, Fenner & Smith Incorporated; and Bear, Stearns & Co., Shearson Hayden Stone Inc., and Loeb Rhoades, Hornblower & Co. On July 3, 1978, the Second Circuit denied petitioners' timely Petition for Rehearing or, Alternatively, Suggestion for Rehearing In Banc (Apps. D and E). Judges Mansfield, Mulligan, Gurfein and VanGraafeiland dissented from the denial of rehearing in banc.

The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

Questions Presented

(1) Can there be any vicarious secondary liability for damages under Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b)), and Rule 10b-5 for aiding and abetting an independent primary fraud committed in violation of that statute and rule by a third party? This is an issue expressly left open by this Court in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 192, note 7 (1976) (hereinafter "*Hochfelder*") for future determination.

(2) If there is such liability what are the elements necessary to establish such a cause of action? This is an issue also expressly left open by this Court in *Hochfelder* for future determination.

(3) In any case asserted against an aider and abettor, such as in the circumstances present here, can liability attach where the fault found was a failure to investigate or make inquiry?

Statute and Rule Involved

Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. §78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5, are set forth as Appendix F to this petition.

Statement of the Case

This case was tried by Judge Pierce, sitting without a jury, in the United States District Court for the Southern District of New York. The trial court entered judgment in favor of plaintiff in the amount of $55,790. That sum was composed solely of commission charges made by BEDCO and interest charges on margin debt in the BEDCO account of plaintiff. It did not include any trading losses. The trial court allowed damage on this basis and in that amount on the finding that:

> "Under the circumstances of this case, all other measures of damage are rejected as wholly speculative with respect to actual injury found by the court to have been caused by the defendants' actions." 424 F. Supp. at 1045; A 94.

The plaintiff appealed on the issue of damage. Defendants BEDCO and Stott cross-appealed on the issue of liability.

The Second Circuit, by a two-to-one decision, affirmed on the finding of liability and, on the issue of damages, reversed and remanded with a direction to the trial court to compute damages in accordance with the guidelines set forth in the decision of the court (A 20-22).

The Court of Appeals held that a securities salesman, Stott of BEDCO, was liable* for trading losses (including losses on transactions with which Stott had no connection**) suffered by plaintiff David Rolf, a sophisticated and experienced customer, found by the trial court to be a trader, not an investor, even though:

> (a) the securities transactions executed in that account were made exclusively at the direction of an independent investment advisor, and not at the direction of Stott or BEDCO;
>
> (b) the investment advisor who directed the account was personally selected by plaintiff and, prior to this episode, had an excellent reputation in the industry;
>
> (c) plaintiff had given the advisor written and exclusive authority to select and trade securities on his behalf, and further instructed the advisor that he desired to conduct a very aggressive investment program involving substantial risks directed toward doubling his equity;
>
> (d) the trading losses were found to have resulted from the fact that the plaintiff's investment advisor was secretly engaged in manipulative and deceptive devices and contrivances directed against, and which constituted a fraud upon, plaintiff; and

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* The securities firm employing the salesman acknowledged below (570 F.2d 38, 48; A 19) and does likewise here, that "for purposes of this appeal" it is vicariously liable by reason of Section 20 of the 1934 Act (15 U.S.C. §78t) as a controlling person. By reason of this acknowledgment, the sole issue presented here is the correctness of the ruling of the court below as to the salesman.

** The majority said that defendants Stott and BEDCO were liable in damages even as respect losses caused by transactions as "to which Stott had no connection because he did not execute the transaction, recommend the security, or reassure Rolf with respect to that security." (570 F.2d at 49; A 22).

(e) the salesman did not know that the advisor was engaged in those furtive and fraudulent practices.

Significantly, the Court of Appeals accepted the findings of the trial court that the salesman "Stott was not aware of the manipulations in the Rolf account" (424 F. Supp. at 1040; A 81) and "did not know of the direct frauds which Yamada was perpetrating on Rolf" (424 F. Supp. at 1043; A 89). Instead the Court of Appeals found the salesman liable as an aider and abettor because it concluded that "recklessness satisfies the scienter requirement" of Section 10(b) of the 1934 Act. In terms of the behavior found to constitute "reckless" conduct, the lower court noted:

> *First,* that the salesman "was aware that the quality of the securities being purchased by [the advisor] was very low" (570 F.2d at 47; A 17);
>
> *Second,* that the salesman repeatedly assured plaintiff "that Yamada knew what he was doing and that if Yamada were purchasing stocks they must be satisfactory" (*id.*); and
>
> *Third,* that the representations were "conclusorily made to Rolf without investigation" (*id.*).

Neither the court below nor the trial court made any finding that there was a causal connection between the breach of the salesman's duty to inquire and the facilitation of the underlying fraud, that is, whether adequate inquiry would have led to a discovery of the primary fraud.

The majority opinion of the Second Circuit Court of Appeals was made in the face of a strong dissent entered by Judge Mansfield and was rendered with the concession by the majority that "the evidence in this case against

Stott, while not overwhelming, is substantial" (570 F.2d at 43; A 8).

After that opinion was issued on January 3, 1978, defendants promptly applied to the Second Circuit Court of Appeals, asking that the appeal be reheard by the Court of Appeals in banc.

Amicus curiae briefs in support of that application were filed by the New York Stock Exchange; the Securities Industry Association; Merrill Lynch, Pierce, Fenner & Smith Incorporated; and Bear, Stearns & Co., Shearson Hayden Stone Inc., and Loeb Rhoades, Hornblower & Co.

Subsequent to the filing of that application, but prior to its denial, the majority amended its opinion by the addition of Footnote 16A* (App. B). Over a month later, on July 3, 1978, the Second Circuit entered on Order denying a rehearing in banc (Apps. D and E; A 97-98). Four active judges dissented from that denial, namely Judges Mansfield, Mulligan, Gurfein and VanGraafeiland.

The Circuit Court's factual and legal determinations might be most effectively summarized by quoting from the dissenting opinion of Judge Mansfield:

> "The majority holds a registered representative (Stott) and his employer (BEDCO) liable under §10(b)

---

* In this added footnote, the majority defined the alleged wrongdoing of Stott to be that he was "aware that the advisor was purchasing junk" and despite that awareness he "actively lulled the investor by expressing confidence in the advisor without bothering to investigate whether these assurances were well-founded." That addition to the majority opinion stands in stark contrast to the statement in the original opinion that the alleged wrongdoing of Stott was that he

> "either recklessly failed to learn of or failed to disclose Yamada's web of fraud." (570 F.2d at 48; A 18).

and Rule 10b-5 to their customer (Rolf) for losses suffered by the customer upon purchases and sales of securities executed at the direction of Rolf's own independent investment adviser (Yamada) pursuant to written discretionary authority from Rolf instructing Stott and BEDCO to follow Yamada's orders. This result is achieved on the grounds that (1) the investment advisor (Yamada) was committing various frauds on the customer (Rolf), and (2) the broker (Stott), although he knew nothing of the frauds, 'aided and abetted' Yamada's conversion of Rolf's account to unsuitable securities by 'holding the hand' of Rolf pursuant to an oral agreement to 'look after' Rolf's account and by assuring him of Yamada's competence as an investment counsel.

"The majority views Yamada's investment of the account in unsuitable securities as fraud in and of itself and Stott's state of mind as recklessness amounting to a deliberate intent to deceive. All of this is too much for me to accept. The majority not only patches together watered-down notions of fraud and scienter in arriving at a result indistinguishable in any significant respect from that reversed by the Supreme Court in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375, 47 L.Ed.2d 668 (1976), but also overlooks findings below and undisputed evidence that foreclose Rule 10b-5 liability.

* * *

"The picture that emerges from these and other statements made by Rolf is one of a sophisticated investor in securities who was well aware of the difference between gilt-edge, relatively safe securities, on the one hand, and speculative 'high fliers,' on the other, and who had determined to get richer quick by choosing an aggressive program involving high-risk, OTC stocks in the hope that his adviser would succeed in picking a few big winners, but well aware of the pitfalls that were involved." 570 F.2d at 50, 53; A 23-24, 30.

Reasons for Granting the Petition

A

This case squarely and directly presents this Court with the legal question of whether or not there is any vicarious civil liability under §10(b) and Rule 10b-5 promulgated thereunder for "aiding and abetting" the primary violation of those provisions by a third party, a question expressly left open for future determination by this Court in *Hochfelder,* at 192, note 7. This case likewise raises the question: what are the elements necessary to establish such a cause of action, assuming it is adjudicated that a claim for aiding and abetting exists?

Both of these questions need resolution by this Court. They are important issues which are currently and continuously being presented for adjudication throughout the federal courts. (See second footnote *infra,* page 10.)

The 1934 Act contains no provision which states or suggests that there is a civil private cause of action for aiding and abetting.* The only express basis for vicarious or secondary liability for the primary wrongs of a third party contained in the 1934 Act is the controlling persons provision of Sec. 20(a) (15 U.S.C. §78t(a)). That section provides:

> "Every person who, directly or indirectly, controls any person liable under any provision of this title or any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such

* The statute does provide sanctions through SEC disciplinary proceedings against registered security dealers who "willfully aided, abetted, counseled, commanded, induced or procured" the violation by another of the prohibitions of the federal securities laws (1934 Act §15(b)(4)(E); 15 U.S.C. §78o(b)(4)(E)).

controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.'"*

Despite the absence of a specific statutory provision, a very large number of cases** decided in Circuit Courts of

* The record and reality in the instant case foreclose any contention that the salesman so controlled the independent investment advisor as to bring into play the above-cited controlling persons liability provision (§20, 1934 Act; 15 U.S.C. §78t). If, however, such a claim could have been made, Stott would have had the defense that he acted in "good faith" and did not "induce" the wrongful acts of which he had no knowledge. Under existing case law, however, the defenses available to a controlling person are apparently not available to an alleged aider and abettor, for the latter is considered an independent and supplementary claim (*SEC* v. *First Securities Co. of Chicago*, 463 F.2d 981, 987 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); *Rochez Brothers, Inc.* v. *Rhoades*, 527 F.2d 880, 886, footnote 10 (3d Cir.), *cert. denied*, 425 U.S. 993 (1976); Ruder, *Multiple Defendants in Securities Law Fraud Cases*, 120 U. Pa. L. Rev. 597, 638 (1972) [hereinafter cited as Ruder, *Multiple Defendants*]. The majority below has apparently ruled that in this case good faith does not constitute a defense to one charged with aiding and abetting a violation of Rule 10b-5 (570 F.2d at 46, note 15; A 15). Of course, in some cases, the controlling evidence might be so similar as to each claim that the same judgment would be reached on both claims. (*Gould* v. *American-Hawaiian Steamship Co.*, 535 F.2d 761, 781 (3rd Cir. 1976)).

** *Bronner* v. *Goldman*, 361 F.2d 759 (1st Cir. 1966), *cert. denied*, 385 U.S. 933 (a factor lending partnership); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969) (a correspondent securities broker); *Brennan* v. *Midwestern United Life Insurance Co.*, 417 F.2d 147 (7th Cir. 1969) (corporate issuer of manipulated stock); *Wessel* v. *Buhler*, 437 F.2d 279 (9th Cir. 1971) (accountant); *Sennott* v. *Rodman & Renshaw*, 474 F.2d 32 (7th Cir. 1973) (securities brokerage firm); *Strong* v. *France*, 474 F.2d 747 (9th Cir. 1973) (potential investor); *Landy* v. *Federal Deposit Insurance Corp.*, 486 F.2d 139 (3rd Cir.), *cert. denied*, 416 U.S. 960 (1974) (securities brokerage firms); *Kerbs* v. *Fall River Industries, Inc.*, 502 F.2d 731 (10th Cir. 1974) (corporate issuer of fraudulent stock certificate); *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974) (stock exchange); *Zabriskie* v. *Lewis*, 507 F.2d 546 (10th Cir. 1974) (agents of principal wrongdoer); *Grimes, Hooper & Messer, Inc.* v.

(footnote continued on next page)

Appeals have established the existence of an implied vicarious and secondary liability for aiding and abetting, premised upon a showing:

(a) That a primary wrong under the federal securities laws had been committed by another;

(b) That the aider and abettor had knowledge of that primary wrongdoing; and

(c) That the aider and abettor had provided substantial assistance in furthering the primary wrongdoing.

Pierce, 519 F.2d 1089 (9th Cir. 1975) (bank and its manager); *Lowenschuss* v. *Kane*, 520 F.2d 255 (2d Cir. 1975) (tender offer participants); *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975) (bank); *Gould* v. *American-Hawaiian Steamship Co.*, 535 F.2d 761 (3rd Cir. 1976); *Rochez Brothers, Inc.* v. *Rhoades*, 527 F.2d 880 (3rd Cir.), *cert. denied*, 425 U.S. 993 (1976) (issuer in a shareholder sale among insiders); *Murphy* v. *McDonnell & Co.*, 553 F.2d 292 (2d Cir. 1977) (stock exchanges); *Hirsch* v. *duPont*, 553 F.2d 750 (2d Cir. 1977) (stock exchange); *Coleco Industries, Inc.* v. *Berman*, 567 F.2d 569 (3rd Cir. 1977), *petition for cert. filed*, 46 U.S.L.W. 3766 (June 2, 1978) (No. 77-1725) (corporate sellers in an acquisition); *Bosser* v. *Magazine*, Fed. Sec. L. Rep. (CCH) ¶96,304 (D.C. Cir. 1977); *Nelson* v. *Serwold*, Fed. Sec. L. Rep. (CCH) ¶96,399 (9th Cir.), *petition for cert. filed*, 47 U.S.L.W. 3071 (July 26, 1978) (No. 78-182); *Monsen* v. *Consolidated Dressed Beef Company, Inc., et al.*, Fed. Sec. L. Rep. (CCH) ¶96,479 (3rd Cir.), *petition for cert. filed*, 47 U.S.L.W. 3168 (Sept. 8, 1978) (No. 78-404) (bank).

In addition, there are a number of cases involving Securities Exchange Commission injunctive or disciplinary proceedings which also deal with the elements of aiding and abetting. *Nees* v. *SEC*, 414 F.2d 211 (9th Cir. 1969) involving aiding-abetting in a disciplinary proceeding prior to the statutory amendment adding willful abetting as a basis for such a proceeding (*Id.* at 220, footnote 6); *Gross* v. *SEC*, 418 F.2d 103 (2d Cir. 1969); *SEC* v. *First Securities Co. of Chicago*, 463 F.2d 981 (7ts Cir.), *cert. denied*, 409 U.S. 880 (1972); *SEC* v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975); *SEC* v. *Coven*, Fed. Sec. L. Rep. ¶96,462 (2d Cir. 1978). Though some of these cases may be inapposite, because different standards of fault or proof may subsist (e.g., "negligence" rather than scienter), others of them may appropriately be used in considering the significance of the issue presented and the conflict of law that has emerged.

In none of these cases has a Circuit Court denied the existence of such an implied vicarious civil liability for damage claims under the federal securities laws.*

We do not find it appropriate in this petition to address the substantive question as to what response this Court should give to the question this Court raised in *Hochfelder*, namely "whether civil liability for aiding and abetting is appropriate under the section and the rule" (425 U.S. at 192, Note 7). Rather, our further discussion as to the elements necessary to establish such liability is made on the assumption, *arguendo*, that aiding and abetting is a predicate for civil liability.

The primary focus and major issue in the instant case rests upon the second of the three accepted elements of aiding-abetting liability: what is the nature and extent of knowledge that must be demonstrated to impose civil liability for aiding and abetting?

The court below found that Stott had the requisite "knowledge" in the following circumstances:

> "Stott was aware that the quality of the securities being purchased by Yamada was very low. . . . Stott's most egregious breach of his duty to Rolf was his constant reassurance that Yamada knew what he was doing and that if Yamada were purchasing stocks they must be satisfactory. These representations were conclusorily made to Rolf without investigation and with utter disregard for whether there was a basis for the assertions." 570 F.2d at 47-48; A 17.

Elsewhere the court found that Stott was "aware that the advisor was purchasing junk" and despite that awareness he "actively lulled the investor by expressing confidence in the advisor without bothering to investigate whether these assurances were well founded." (See footnote added, App. B; A 40). Finally we note the comment of the majority that Stott

> "either recklessly failed to learn of or failed to disclose Yamada's web of fraud." 570 F.2d at 48; A 18.

Clearly the essence of the majority opinion of the lower court was that the aiding and abetting liability of Stott derived from an *omission*, namely, a failure to investigate. Conversely, the lower court did not predicate liability upon the basis that Stott had actual knowledge of the underlying violation, or even that he had a knowing participation or conscious involvement in the securities fraud of the investment advisor.*

Other Circuit Court decisions drastically depart from this rule of law pronounced by the lower court and require, as a condition of holding a defendant liable as an aider and

* However, one District Court has said: "This court is of the opinion that where a statute specifically limits those who may be held liable for the conduct described by statute, the courts cannot extend liability, under a theory of aiding and abetting, to those who do not fall within the categories of potential defendants described by the statute. To impose such liability would circumvent the express intent of Congress in enacting those statutes that proscribe narrowly defined conduct and allow relief from precisely defined parties." *In re Equity Funding Corp. of America Securities Litigation*, 416 F. Supp. 161, 181 (C.D. Calif. 1976).

* The Second Circuit in another case has said:

> "an aider and abettor will be held liable if he assisted the principal with knowledge of material falsity or *was reckless in determining the existence of material falsity. . . .*" *Lowenschuss* v. *Kane*, 520 F.2d 255, 268, footnote 10 (2d Cir. 1975; emphasis added throughout unless otherwise indicated).

abettor, that he have a knowing and conscious awareness that a federal securities law fraud is being perpetrated upon the plaintiff by the primary wrongdoer.

The Sixth Circuit has announced its adherence to an actual knowledge requirement as follows:

> "a person may be held as an aider and abettor only . . . if the accused party had general awareness that his role was part of an overall activity that is improper. . . ." *SEC* v. *Coffey*,o 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

The Sixth Circuit clearly concluded that unless an alleged aider and abettor was "aware" or "knew" the primary wrongdoers were making misleading statements to the plaintiff, no aiding-abetting liability could attach. *Id.* at 1316.**

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* This court and others reaching a like definition drew upon the Restatement of Torts ¶876 (1939) which would impose liability for the tortious conduct of another person or entity only if the defendant "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself."

** The court also made the following pertinent observation:

> "Normally, intent to commit a securities law violation does not require independent proof. [citations omitted]. Knowledge that a securities law violation would be furthered by one's silence or inaction, however, must be proven by reliable and probative evidence [citations omitted], though the evidence may be circumstantial as well as 'direct.' [citations omitted]. Were such proof not required, a person who is not primarily liable for a violation could yet be held personally liable for the violation, even though he or she was unaware of the need to disclose information withheld by those primarily liable. The result would be to impose liability for an innocent omission, for non-culpable inaction. This would stretch the application of Rule 10b-5 beyond its statutory limits, since section 10b of the 1934 Act does not impose liability for innocent acts but only for acts of fraud or deceit. [footnotes omitted]" *Id.* at 1317.

The Tenth Circuit likewise has adopted a knowledge standard. It has said:

> "When liability is to be imposed on participants, aiders and abettors, and co-conspirators *knowing participation in the fraudulent scheme must be shown.*" *Zabriskie* v. *Lewis*, 507 F.2d 546, 554 (10th Cir. 1974).

The Fifth Circuit has also adopted a knowledge standard. *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84, 96 (5th Cir. 1975). It has stated:

> "[A]s Professor Bromberg pointed out, 'the clue to liability is some sort of knowledge.' [citations omitted] Knowledge may be shown by circumstantial evidence, or by reckless conduct, but the proof must demonstrate *actual awareness of the party's role in the fraudulent scheme.* As Professor Ruder argued, using an example remarkably similar to the case at hand:
>
> > 'If all that is required in order to impose liability for aiding and abetting is that illegal activity under the securities laws exists and that a secondary defendant, such as a bank, gave aid to that illegal activity, the act of loaning funds to the market manipulator would clearly fall within that category and would expose the bank to liability for aiding and abetting. Imposition of such liability upon banks would virtually make them insurers regarding the conduct of insiders to whom they loan money. If it is assumed that an illegal scheme existed and that the bank's loan or other activity provided assistance to that scheme, some remaining distinguishing factor must be found in order to prevent such automatic liability. The bank's knowledge of the illegal scheme at the time it loaned the money or agreed to loan the money provides that additional factor. *Knowledge of wrongful purpose thus becomes a crucial element in*

aiding and abetting or conspiracy cases. Ruder, *supra* note 23, at 630-31.' " *Id.* at 96.

The Fifth Circuit concluded that

> "before someone can be caught within the net of aiding and abetting liability under Rule 10b-5 . . . the alleged aider-abettor must be generally *aware* of his role in improper activity, and he must *knowingly* render substantial assistance. Without these limitations, the securities laws would become an amorphous snare for guilty and innocent alike." *Id.* at 97.*

The Third Circuit has also recently stated its adherence to a knowledge requirement. It has said:

> "*Knowledge of the underlying violation* is a critical element in proof of aiding-abetting liability, for without this requirement financial institutions, brokerage houses, and other such organizations would be virtual insurers of their customers against security law violations. Culpability of some sort is necessary to justify punishment of a secondary actor and mere unknowing participation in another's violation is an improper predicate to liability." *Monsen* v. *Consolidated Dressed Feef Company, Inc., et al.*, Fed. Sec. L. Rep. (CCH) ¶96,479 at 93,764 (3d Cir.), *petition for cert. filed*, 47 U.S.L.W. 3168 (Sept. 8, 1978) (No. 78-404).

Applying this standard, the Third Circuit in *Monsen* held a bank liable as an aider and abettor, although it was careful

* Elsewhere the Fifth Circuit has ruled that Rule 10b-5 scienter cannot be shown by claiming that a defendant "should have known" and the Ninth Circuit has likewise so ruled. *Gottreich* v. *San Francisco Instrument Corp.*, 552 F.2d 866 (9th Cir. 1977); *Crocker-Citizens National Bank* v. *Controls Metal Corp.*, 566 F.2d 631 (9th Cir. 1977). In this regard, see comment in Footnote 16 of the lower court opinion, A 17.

to emphasize the distinction between its finding and that in *Woodward, supra*, where a bank was found to be innocent:

> "As is evident, in *Woodward* the plaintiff did not establish the bank's knowledge of its borrower's fraud. *That lack of knowledge is the critical difference* between that case and the instant one." *Id.* at 93,767, footnote 18.

The *Monsen* ruling in fact comports with an earlier Third Circuit decision where that court said:

> "If liability is to be imposed on a secondary defendant, the plaintiff must show *a knowing participation* or *conscious involvement* in the fraudulent scheme." *Rochez Brothers, Inc.* v. *Rhoades, supra* at 888-89.

It is meaningful that the Third Circuit issued its recent opinion in *Monsen* with a realization that its earlier decision in *Landy* v. *Federal Deposit Insurance Corp.*, 486 F.2d 139 (3rd Cir. 1973), *cert. denied*, 416 U.S. 960 (1974), had been criticized by the Fifth Circuit.

The Fifth Circuit (*Woodward* v. *Metro Bank of Dallas, supra* at 94-95), specifically criticized the Third Circuit's definition in *Landy* because of its depreciation of the importance of "knowledge" on the part of the alleged secondary wrongdoer:

> "The elements adopted by the Third Circuit in *Landy* v. *Federal Deposit Ins. Corp.*, 3 Cir. 1973, 486 F.2d 139, *cert. denied*, 1974, 416 U.S. 960, 94 S. Ct. 1979, 40 L. Ed. 2d 312, are similar to the *Coffey* test, but *Landy* refers to 'an independent wrong' instead of a securities law violation, and knowledge of the wrong's existence instead of awareness of a role in improper activity. Finally, *Landy* omits the 'knowing' require-

ment for the substantial assistance aspect. The first two *Landy* elements pose a danger of over-inclusiveness and seem to lose sight of the necessary connection to the securities laws. One could know of the existence of a 'wrong' without being aware of his role in the scheme, and it is the participation that is at issue. The scienter requirement scales upward when activity is more remote; therefore, the *assistance rendered should be both substantial and knowing. A remote party must not only be aware of his role, but he should also know when and to what degree he is furthering the fraud.*" *Id.* at 95. (Footnote omitted.)

This analysis of the leading Circuit Court cases demonstrates, we submit, a meaningful and significant conflict on an issue of wide and growing importance between the Second Circuit on the one hand, and the Third, Fifth, Sixth and Tenth Circuits on the other.

Petitioner contends that a showing of "recklessness", which falls short of establishing that the defendant was knowingly and consciously involved in the primary fraud, is insufficient to make out the secondary and vicarious liability of an aider and abettor, whether or not recklessness is sufficient for scienter on the part of the principal wrongdoer who directly participates in and by his own act commits the actual violation of Rule 10b-5.*

Such a knowledge standard discourages the unwarranted inclusion in a federal securities fraud case of persons who are remote from the actual fraud. The ingenious

* "The existence of a knowledge requirement in order to impose [aider and abettor liability] should be distinguished from the question whether scienter is a necessary element to establish liability for the primary participant." (Ruder: *Multiple Defendants, supra* at 10, first footnote, at 631).

efforts of victims of securities frauds to enlist on their behalf vague concepts of aiding and abetting have enmeshed such third party strangers to the real fraud as banks, stock exchanges, correspondent securities dealers, accountants, potential and affluent fellow investors, issuers in the disputes of their controlling insiders and many others.*

We believe that this Court has already indicated a compelling need for imposing restrictions on the unbounded extension of the federal securities laws to alleged aiders and abettors. *Santa Fe Industries* v. *Green*, 430 U.S. 462 (1977).

In *Hochfelder*, this Court, in referring to the elements necessary to establish a cause of action for aiding and abetting, cited the landmark *Brennan* case** and characterized it as one where the defendant "gave active and *knowing* assistance to a third party engaged in violations of the securities laws." 425 U.S. at 192, footnote 7.

This Court in its *Hochfelder* opinion also cited Professor Ruder's learned treatises on aiding and abetting.† That article emphasized that the "*exact identification* of the wrong is essential in order to determine which persons should be subject to liability for giving knowing assistance to . . . the primary participants in the wrongdoing." (*Id.* at 630).

* See cases cited second footnote, *supra* at 10.

** *Brennan* v. *Midwestern United Life Insurance Co.*, 259 F. Supp. 673 (N.D. Ind. 1966) and 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir.), cert. denied, 397 U.S. 989 (1970).

† Ruder, *Multiple Defendants, supra* at 10, first footnote, at 620-645.

"Once the independent wrong has been established, aiding and abetting liability will depend upon a showing that the defendant *knew* of the wrong and gave assistance to the wrongdoer." *Id.* at 630.

We submit that the majority below failed to satisfy these requirements in holding Stott liable as an aider and abettor. As Judge Mansfield properly noted:

"Because even the majority concedes that 'Stott was ignorant' of Yamada's 'stock manipulations,' it becomes important to determine what was the fraud 'aided and abetted' by Stott through some 'reckless disregard' on his part. The majority opinion, making precious little mention of any frauds committed by Yamada, fails completely to describe or analyze the specific fraud or frauds that were furthered by Stott other than to suggest that they were 'Yamada's investment decision' and his conversion of Dr. Rolf's portfolio into securities that were highly speculative and of very low quality compared with the type of securities that had been there when the account had been managed directly by Mr. Stirling of BEDCO. What the district court labelled 'tantamount to fraud' —Yamada's investment of Rolf's account in unsuitable securities, so-called 'high fliers,' 'junk,' or 'low quality' issues—is characterized by the majority in conclusory fashion as part of 'a more exhaustive and all-encompassing web of fraud.' The majority's forbidding label cannot alter the fact that, when this case is stripped of the brooding omnipresence of Yamada's flagrant manipulations as it must be, nothing remains but an unfocused allegation that Stott lulled Rolf into acquiescence in Yamada's investment of his account in unsuitable securities." 570 F.2d at 50-51; A 24-25.

Professor Ruder gave particular emphasis to a principle whose existence is a major reason why this Court should hear this case.

"As aiding and abetting . . . liabilities in the securities field develop, careful consideration of knowledge requirements is essential in order to achieve sound and balanced policy." *Id.* at 630.

B

One cannot escape the conclusion that the critical and ultimate issue which predominates the instant case is the legal issue of whether Professor Ruder was right when he stated:

"[I]mposition of a duty to investigate . . . in essence would amount to eliminating scienter as a necessary element in imposing aiding and abetting liability and the substitution of a negligence standard." *Id.* at 633.

As we have already shown, the lower court opinion did not predicate liability upon the existence in defendant Stott of a knowing, personally held purpose and intent to defraud or cheat the plaintiff. Rather, the lower court expressly found aiding and abetting liability as to defendant Stott predicated upon his failure to investigate. The lower court said:

"In the present case, the broker-dealer, although charged with supervisory authority over the advisor and aware that the advisor was purchasing 'junk,' actively lulled the investor by expressing confidence in the advisor *without bothering to investigate* whether these assurances were well-founded." Footnote 16A, Appendix B; A 39-40.

We contend that "scienter", which is an essential element in making out a Rule 10b-5 claim, cannot, either as to

the primary wrongdoer or as to an aider and abettor, be founded upon the showing of an uninformed misrepresentation whose falsity might only have been discoverable by the speaker if a considerable investigation had been made by him. The dissenting opinion of Judge Mansfield below summarizes the essential failure of the majority to recognize the law in this area as established by this Court:

> "even conceding that Stott believed some or many of Yamada's purchases to be 'junk,' it would have required a considerable investigation for him to determine whether Yamada's widely-recognized reputation for brilliance was unwarranted or whether the ratio of risk to return on Rolf's portfolio as a whole was consonant with the doctor's investment objectives. A failure to perform such an investigation without more does not, after *Hochfelder,* establish scienter." 570 F.2d at 52; A 28.

This case does not present a situation in which the speaker (Stott) made statements which he knew to be false or which were grounded on facts so flimsy as to lead to the conclusion that there was no genuine belief by the speaker in the truth of those statements. Nor does it present a situation where the representation was made as to a matter upon which the speaker had no knowledge at all. *State Street Trust Co.* v. *Ernst,* 278 N.Y. 104, 112, 15 N.E.2d 416, 418-419 (1938). If this case reflected or represented such a situation as those just defined, the wrongdoing would have been primary, not secondary.

Rather, this case presents a situation where the speaker made statements as to the competence of the investment ad-

visor (Yamada) which statments are substantiated by the trial court's findings.

> "Yamada, the son of a wealthy Japanese industrialist, had attended Harvard Business School for one year prior to 1965 when he joined the investment banking firm of Kuhn Loeb & Co. (Tr. 557). Yamada described Kuhn Loeb as a conservative and prestigious firm which generally handled 'triple-A' clients (Tr. 509). At Kuhn Loeb, Yamada eventually became an officer of the firm purportedly with expertise in research and 'special situations'. In 1969, at the age of 26, Yamada left Kuhn Loeb to form an investment partnership; during the period of the complaint he was not associated with any research firm or brokerage house (Tr. 558).
>
> "Yamada was described at trial by John P. Cione, BEDCO's chief compliance officer, as one of a 'new breed' of young money-managers who emerged as highly successful in the stock market during 1969 and 1970. Yamada was committed to 'special situations' and was one of a number of young advisers who were making mutual funds, hedge funds, and assorted speculative ventures very profitable (Tr. 1111). During the period of the complaint Yamada was handling six sizeable portfolios, three institutional and three individual, of which Dr. Rolf's was the largest individual account." 424 F.Supp. at 1021; A 46.

Based upon the background and reputation of the advisor and however erroneous in hindsight the assurances turned out to be, it could not be said that the statements when made were spoken with a knowledge of their falsity, or were grounded on facts so flimsy as to warrant a conclusion that there was no genuine belief in their correctness or that the statements were given upon a matter as to which the speaker had no knowledge at all.

Despite all of this, the court below adjudicated that as a matter of law the defendant Stott was liable because the statements were made "without investigation," and were made in the face of the fact that Stott "failed to learn of . . . Yamada's web of fraud" (570 F.2d at 47-48; A 17-18).

We submit that other decisions in the Second Circuit itself are in conflict with the majority decision of the lower court.

The decision below is in direct conflict with the majority opinion *en banc* of the Second Circuit in *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973). In fact, it might be fair to say that the majority opinion below of Circuit Judges Oakes and Smith rests upon, adopts and follows the minority opinion in *Lanza*, which minority opinion was in fact supported by those same two judges.

In the *Lanza* case, an outside director, aware that the officers of his company were negotiating for the disposition of its stock in an exchange offering, failed to inquire to determine whether those officers were making material misstatements and omissions. In fact the officers were engaged in such fraudulent misconduct to the injury of the purchaser who claimed against the director for aiding and abetting those officers in their violation of Rule 10b-5. *Id.* at 1289. The Second Circuit found that the director did not participate in the negotiations and did not know that the corporate officers were engaged in fraudulent misconduct. The court also found that the director "knew many disquieting facts" about his company but could not find

that his "failure to inquire was in any way willful or calculated." *Id.* at 1304.

The Second Circuit majority (by a six-to-four vote) ruled in *Lanza* that:

> "a plaintiff claiming a violation of Rule 10b-5 who cannot prove that the defendant had *actual knowledge* of any misrepresentations and omissions must establish, in order to succeed in his action, that the defendant's failure to discover the misrepresentations and omissions amounted to a willful, deliberate or reckless disregard for the truth that is the equivalent of knowladge." *Id.* at 1305.

Applying such a standard, the court exonerated the director because it was not proven that the director "willfully closed his eyes to or turned his back on the fraudulent nature of the . . . negotiations" conducted by the corporate officers. *Id.* at 1306.

As further evidence of this problem in the Second Circuit, we would point to the court's recent decision in *SEC* v. *Coven*, Fed. Sec. L. Rep. (CCH) ¶96,462 (2d Cir. 1978) (opinion by Judge Mansfield), an SEC enforcement proceeding. There the court held that §17(a) of the 1933 Act (unlike §10(b) of the 1934 Act) does not require a showing of scienter so that a negligence standard would be applied. On the facts, although the court found a violation as to a lawyer's failure to comply with an escrow provision of a new securities offering, it refused to find him secondarily liable, *even for negligence*, relating to the underwriter's fraud:

> "Absent some concrete indication of knowledge by appellant that an underwriter was engaged in wrongful

trading, we do not think that as attorney for the issuer he was under an obligation to investigate trading in the issuer's securities to determine whether an underwriter was so engaged." *Id.* at 93,681.

* * *

"While we think that appellant showed bad judgment in failing to make the minimal inquiries . . . we cannot conclude that he 'should have known' that his inaction would further illegal activity." *Id.* at 93,682.

We submit that the present Seventh Circuit formulation is also in conflict with the lower court holding in this case.

When this Court decided the *Hochfelder* case, it remanded another important and related case* to the Seventh Circuit "for further consideration in light of" *Hochfelder.*** On that remand, the Court of Appeals reversed its prior ruling against a commercial paper underwriter for its failure to adequately investigate and denied recovery on an aider and abettor basis under Rule 10b-5.†

The Seventh Circuit defined the case before them in these terms:

> "The district court held (the *under*writer) liable on the theory that it breached a duty to make reasonable inquiries that would have led to the discovery of issuer's fraud." *Id.* at 792.

Concluding that there was no "showing of actual intent to deceive, manipulate or defraud," the Seventh Circuit

* *Sanders* v. *John Nuveen & Co., Inc.*, 554 F.2d 790 (7th Cir. 1977).

** 425 U.S. at 929.

† *Sanders, supra* at 798.

declared that "reckless behavior can be sufficient to constitute scienter." *Id.* It stated, however, that the definition of such conduct "should not be a liberal one lest any discernible distinction between 'scienter' and 'negligence' be obliterated."

> "We believe 'reckless' in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind." *Id.* at 793.

The court then applied these rules to the facts in that case, giving particular recognition to the fact that the underlying fault was that the underwriter's "investigation of the issuer was deficient and that an appropriate examination would have revealed the issuer's fraud." *Id.* The court then adjudicated that the underwriter was not in violation of Rule 10b-5 because:

> "There was no finding that Nuveen's acts of commission or omission were reckless, that is, that they were so highly unreasonable and such an extreme departure from the standards of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Id.; see also Wright* v. *Heizer Corp.*, 560 F.2d 236, 251-52 (7th Cir. 1977), *cert. denied* 434 U.S. 1066 (1978).

The Seventh Circuit in another case, *Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied* 434 U.S. 875 (1977), also enunciated the requirement that recklessness must constitute an extreme departure from the standards of ordinary care. That court said that "the danger of misleading buyers must be actually known or so obvious that a reasonable man would be legally

bound as knowing." *Id.* at 1045. It made clear that application of this test must be made in the light of the facts existing at the time and not "in the blazing light of hindsight." *Id.*, footnote 19. The plaintiffs must show something more than " 'inexcusable negligence.' " *Id.*, footnote 20.

It seems obvious that the standard enunciated by the Seventh Circuit is in plain conflict with the standard enunciated by the lower court.

We would add that the Seventh Circuit standard enunciated in *Nuveen* after this Court's remand, appears to conflict with two earlier Seventh Circuit opinions which had adopted a standard similar to the doctrine established by the lower court:

> "[W]e would not go so far as to charge a party with aiding and abetting who somehow unwittingly facilitated the wrongful acts of another. Rather, to invoke such a rule investors must show that the party charged with aiding and abetting had knowledge of or, *but for a breach of duty to inquiry, should have had knowledge of the fraud . . .*" *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364, 374 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974).

Also—

> "It is clear that one who aids and abets a violation of . . . Rule 10b-5 may be held civilly liable to one who is injured thereby [citing cases]. Moreover, liability predicated on aiding and abetting may be found on *less than actual knowledge and participation in the activity proscribed by* . . . Rule 10b-5." *SEC* v. *First Securities Co. of Chicago*, 463 F.2d 981, 987 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

This change by the Seventh Circuit would seem readily explicable in that these earlier cases enunciated a standard rejected by this Court in *Hochfelder*. By similar reasoning, we submit that the lower court's opinion, comporting substantially with these earlier Seventh Circuit holdings, must also be reversed.

C

This petition has demonstrated that there is a developed and meaningful body of law announced in the Circuits on the issue of whether civil liability for aiding and abetting is appropriate and identifying the elements necessary to establish such a cause of action.

It is evident that the final resolution by this Court of the still open question of whether aiding-abetting liability can be imposed for a Rule 10b-5 violation, and the final enunciation by this Court of the elements constituting that liability is of wide and far-reaching importance to the federal courts in their conduct of civil suits for damages under Rule 10b-5.

We respectfully submit that the time has come for this Court to confront and resolve these issues so as to assure the establishment of sound and balanced policy in the application of the law to secondary defendants and to foreclose undue extension of the law to parties remote from the primary and principal wrongdoer.

Conclusion

For all the reasons set forth above, a Writ of Certiorari should be granted to review the opinion and judgment of the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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Dated: October 2, 1978

Appendices

APPENDIX A

Opinion of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Nos. 22 and 405, Dockets 77-7104 and 77-7124

DAVID E. ROLF,

Plaintiff-Appellant-Cross-Appellee,

v.

BLYTH, EASTMAN DILLON & CO., INC. and MICHAEL SCOTT,

Defendants-Appellees-Cross-Appellants.

Argued Oct. 12, 1977

Decided Jan. 3, 1978

Sidney B. Silverman, Silverman & Harnes, New York City, for plaintiff-appellant-cross-appellee.

Thomas W. Kelly, Breed, Abbott & Morgan, New York City (Robert G. Kuhbach, Charles Siegel, New York City, of counsel), for defendants-appellees-cross-appellants.

Before SMITH, MANSFIELD and OAKES, Circuit Judges.

OAKES, Circuit Judge:

On cross appeals from a judgment of the United States District Court for the Southern District of New York, Lawrence W. Pierce, Judge,[1] plaintiff David E. Rolf (Rolf)

1. The opinion below is reported at 424 F.Supp. 1021 (S.D. N.Y. 1977).

endorses the district court's holding on questions of liability, but challenges the district court's measure of damages. Defendants in turn attack the district court's theories of liability. In the court below, Judge Pierce imposed aiding and abetting liability on defendant Michael Stott (Stott) and derivative liability on his employer, Blyth, Eastman Dillon & Co., Inc. (BEDCO), for Stott's substantial assistance to and participation in a web of securities fraud perpetrated by defendant Akiyoshi Yamada (Yamada),[2] contrary to §10(b) of the Securities Exchange Act of 1934 (SEA), 15 U.S.C. §78j(b) and Rule 10b-5 thereunder, 17 C.F.R. §240.10(b) 5. Judge Pierce also implied a private cause of action under New York Stock Exchange (NYSE) Rule 405 and under Article III, Section 2 of the constitution of the National Association of Securities Dealers (NASD). The Judge then awarded damages and interest totaling $55,790. We agree with Judge Pierce on the aiding and abetting liability of Stott. We therefore affirm as to him and in view of BEDCO's acknowledgment for purposes of this appeal that it is vicariously liable by reason of Section 20 of the 1934 Act, 15 U.S.C. §78t(a), affirm also as to it. Brief for Defendants-Appellees-Cross-Appellants at 28n.* Accordingly, we do not reach the question whether there is an implied cause of action under the NYSE rule or the NASD constitution. We disagree with Judge Pierce on the measure of damages, however, and accordingly remand for reconsideration thereof.

2. Yamada and Rolf settled their differences; Yamada is therefore not a party to the cross appeals.

I

Facts

Rolf is an ophthalmologist from Shaker Heights, Ohio. Long an investor and an aggressive trader in the stock market, he began his association with Eastman Dillon Union Securities & Co., BEDCO's predecessor firm, in 1963 when he entrusted a discretionary account to S. Logan Stirling, a partner of the firm. The value of Rolf's portfolio at that time was approximately $400,000. In March of 1969 Stirling was forced to retire owing to ill health. At the end of April, a BEDCO partner assigned the Rolf account to Stott, a registered representative with the firm for 11 years during 4 of which he was a manager of BEDCO branch offices. Stott then telephoned Rolf and offered his services. Rolf, however, wanted an investment advisor to manage his account, not simply a broker. Stott, therefore, at Rolf's request, supplied the names of two investment advisors. Rolf ultimately interviewed and selected Yamada, one of the "new breed" of young money-managers with supposed expertise in research and "special situations."

The district court found that Rolf's investment intent was to combine Yamada's and Stott's strengths into a "Stirling-type" operation, 424 F.Supp. 1021, 1028 (1977). By combining Yamada's youth and zeal with Stott's reliability and supervision, Rolf hoped to realize, as he had with Stirling's advice, substantial capital gain in an investment program emphasizing preservation and augmentation of capital. In furtherance of these investment objectives, Rolf executed a broad authorization giving his investment

advisor, Yamada, full trading discretion. Rolf left the account and its accompanying trading commissions with Stott and BEDCO in return for Stott's supervision of Yamada.

On May 9, 1969, the date of the trading authorization, Rolf's equity in his portfolio stood at $1,423,000. The portfolio consisted of 21 good quality, listed securities and the warrants of two companies.[3] By January of 1970 Yamada had liquidated the entire portfolio, selling 14 issues at a loss. The net value of Rolf's portfolio had declined to approximately $712,000 of which $338,000 was invested in the restricted stock of Delanair, Inc.[4] During this period of portfolio liquidation, Yamada and Stott were in daily contact. The district court found that out of 41 issues purchased for Rolf in the complaint period Stott "either recommended or was somehow involved with the decision to purchase" 12 securities, some of which were highly speculative. *Id.* at 1030.[5]

3. The securities included Anaconda Co., Asamera Ail Corp., Avnet Inc., Buttes Gas & Oil Co., CNA Financial Corp., Cities Service Co., Ebasco Industries Inc., Glen Alden Corp., INA Corp., International Industries Inc., General Electric Co., Leesona Corp., Levin Townsend Computer Corp., Loew's Theatres Inc., National General Corp., Occidental Petroleum Corp., Penn Central Co., Pittson Co., Raytheon Corp., Scientific Resources Corp., Teledyne, Inc., Loew's Theatres (warrants), and Leasco Data Processing (warrants).

4. At this time the portfolio consisted principally of securities sold over the counter (OTC) and of low quality: Delanair, Inc. (restricted), Food Fair Properties, Inc., Holobeam, Inc., Monarch Industries, Inc., Synchronex Corp., West Coast Production Co., Benquet Consolidated Corp., Equity Funding Corp., Outlet Company, and Simplex Wire & Cable Co.

5. These included Simplex Wire & Cable Co., Teradyne, Inc., Standard Oil of New Jersey, Reading & Bates Offshore, Intertherm, Inc., Food Fair Properties, International Funeral, Natomas Corp., Asamera Oil Corp., Carter Wallace, Inc., West Coast Production, and Equity Funding Corp.

With the rash of new, unfamiliar securities which found their way into Rolf's portfolio, Rolf became concerned and sought assurances from Stott as early as July, 1969. Specifically Rolf wished to ascertain that Yamada's purchases were consistent with the former's investment goals and strategy. To assuage Rolf's fears, the district court found, Stott undertook a hand-holding operation whereby Stott would reassure Rolf of Yamada's competence whenever Rolf questioned it. *Id.* at 1031. For example, when in August, 1969, Yamada decided to purchase nearly $400,000 in Delanair stock, Rolf checked with Stott who assured the doctor that if Yamada recommended the stock, then it was safe to proceed.

By March 29, 1970, the value of Rolf's portfolio had dropped to $446,000 of which nearly one-half was tied up in Delanair. In early April, Rolf complained to Stott who began to assume the posture that he was a mere "order taker." Rolf disagreed with this self-description, asking Stott to "work closely with Aki," and reminded Stott that Stott was his "man in N.Y." *Id.* at 1032-33. Later, on December 14, 1970, Rolf again asked Stott to "keep [his] pulse on the situation."

The district court discredited Stott's testimony that he was not involved in the management of Rolf's portfolio specifically finding that Stott was in fact so enmeshed. *Id.* at 1028, 1030, 1031. Stott and Yamada were in daily contact. Stott made numerous recommendations to Yamada for Rolf accounts using BEDCO research analysis, *id.* at 1030, but never counseled against a Yamada purchase. *Id.* at 1033. And most of the trades were executed through Stott at BEDCO. For those stocks purchased through

other brokerage houses, because of BEDCO internal rules, Stott received confirmation slips. Additionally, such securities were delivered to and held by BEDCO.

The district court's finding on the question of Stott's attitude toward the quality of the purchases is not altogether clear. The lower court states on the one hand that it gives "*some* weight to Yamada's statement that Stott referred to the stocks in the Rolf account as 'junk,'" *i.e.*, of very low quality. *Id.* at 1033 (emphasis added). But the Judge goes on to conclude "that Stott did indeed consider many of the securities to be 'junk' and that he told this to Yamada." *Id.*

The district court unequivocally found, however, that Yamada was engaged in fraudulent stock manipulations, of which Stott was ignorant. The district court also concluded unambiguously that Yamada's overall management of the account was fraudulent in nature, over and above the specific manipulations of which Stott was unaware. *Id.* at 1043. Stott was of course knowledgeable that many of the securities purchased for Rolf were highly speculative, "high-fliers." *Id.* at 1035. Nevertheless, neither Stott nor BEDCO ever identified any security as unsuitable for Rolf. *Id.* at 1036. Stott's services to Rolf consisted solely of certain "buy" recommendations, executing transactions and performing the accompanying paperwork. The court concluded that

> Stott's practice of continually voicing his confidence in Yamada and in Yamada's investment decisions constituted a fraud upon Dr. Rolf, who sincerely believed that Stott had some basis for his statements. The statements of support and the assurances which were repeatedly made were made with willful and reckless disregard for whether they were true or false.

Id. at 1042.

II

District Court Holding

The district court based liability on alternative legal theories. The first was that Stott owed a fiduciary duty to Rolf which he breached; that by virtue of that breach Stott aided and abetted Yamada's fraud and was therefore liable under §10(b) of the SEA, 15 U.S.C. §78j(b), and Rule 10b-5 thereunder, 17 C.F.R. §240.10(b)-5; and that BEDCO's liability for Stott's participation in Yamada's fraud derives alternatively from the common law doctrine of respondeat superior or the securities law doctrine of controlling persons liability, §20(a), SEA, 15 U.S.C. §78t (a). The district court also rested liability on an implied private cause of action from violations of NYSE Rule 405 and the NASD constitution, Article III, Section2.[6] The Judge then awarded damages of $55,790, on a "churning"

6. There is no case decided by this court upholding, but there are several cases discussing, this theory of liability. NYSE Rule 405 requires a broker to "know [his] customer." Art. III §2 NASD imposes supervision and suitability requirements on brokers. *See Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 141 (7th Cir.), *cert. denied*, 396 U.S. 838, 90 S.Ct. 98, 24 L.Ed. 2d 88 (1969); *Starkman* v. *Seroussi*, 377 F.Supp. 518 (S.D.N.Y. 1974); *cf. Colonial Realty* v. *Bache & Co.*, 358 F.2d 178 (2d Cir.) (no liability under 1934 act for failure to employ "just and equitable" principles of trade as required by NASD), *cert. denied*, 385 U.S. 817, 87 S.Ct. 40, 17 L.Ed.2d 56 (1966). *See also Van Alen* v. *Dominick & Dominick, Inc.*, 560 F.2d 547, 552 (2d Cir. 1977); *Van Gemert* v. *Boeing Co.*, 520 F.2d 1373, 1379-82 (2d Cir.), *cert. denied*, 423 U.S. 947, 96 S.Ct. 364, 46 L.Ed.2d 282 (1975).

theory, even though he dismissed plaintiff's churning claim, on the ground that any other measure of damages would be "speculative." 424 F.Supp. at 1045.

III

Standard of Review

At the outset, we note that the evidence in this case against Stott, while not overwhelming, is substantial. We are bound by the district court's findings, as we discern them, on the basis of the clearly erroneous rule. Fed.R. Civ.P. 52(a); *see United States Steel and Carnegie Pension Fund, Inc.* v. *Orenstein*, 557 F.2d 343 (2d Cir. 1977) (sub silentio). We have held on countless occasions that on review of district court findings, "we may not substitute our judgment on facts for that of the trial judge, who was in a superior position to appraise the evidence, and we may not reverse his findings unless, on the entire record, we are ' ' "left with the definite and firm conviction that a mistake has been committed.' " *Zenith Radio Corp.* v. *Hazeltine Research, Inc.*, 395 U.S. 100, 123 [89 S.Ct. 1562, 23 L.Ed.2d 129] (1969), *quoting United States* v. *United States Gypsum Co.*, 333 U.S. 364, 395 [68 S.Ct. 525, 92 L.Ed. 746] (1948)." *Van Alen* v. *Dominick & Dominick, Inc.*, 560 F.2d 547, 550 (2d Cir. 1977). This is true because the trial judge is particularly able to assess the demeanor and credibility of witnesses. *Id.* at 551; *see Newburger, Loeb & Co.* v. *Gross*, 563 F.2d 1057, at 1070 (2d Cir. 1977).

IV

Liability

A. Stott

There is no doubt that Yamada perpetrated a gross fraud upon Rolf in violation of §10(b) and Rule 10b-5. We conclude that Stott, by virtue of assurances of confidence in Yamada and in Yamada's investment decisions and by virtue of his reckless disregard of whether those assurances were true or false and of substantial evidence that Yamada was improperly and fraudulently managing Rolf's account, participated in and lent assistance to the fraud upon Dr. Rolf. The reasoning which leads us to this conclusion follows.

1. *Reckless disregard of truth or falsity as constituting scienter.* The starting point is *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). In *Hochfelder*, the Supreme Court explicitly failed to decide whether §10(b) and Rule 10b-5 may, in appropriate circumstances, give rise to aiding and abetting liability and, if so, the elements of such a cause of action. *Id.* at 192 n. 7, 96 S.Ct. 1375. Although the Supreme Court has, therefore, not passed on the issue, our court has adopted the position that §10(b) and Rule 10b-5 do permit the imposition of aiding and abetting liability. *Hirsch* v. *DuPont*, 553 F.2d 750, 759 (2d Cir. 1977); *see Brennan* v. *Midwestern United Life Insurance Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989, 90 S.Ct. 1122, 25 L.Ed.2d 397 (1970); Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 Colum.L.Rev. 1437, 1448

(1967). Of course, the basic holding of *Hochfelder*, that scienter is an element of the §10(b)/Rule 10b-5 cause of action,[7] also establishes the standard for aiding and abetting liability.[8]

The question then becomes precisely what level of scienter is required in this type of 10b-5 case and whether the district court's findings indicate that plaintiff's proof satisfies that standard. We conclude on one of the questions left open by *Hochfelder*, 428 U.S. at 194, n. 12, 96 S.Ct. 1375, that at least where, as here, the alleged aider and abettor owes a fiduciary duty to the defrauded party,[9] recklessness satisfies the scienter requirement. We arrive at this conclusion for several reasons.

First, by leaving open the possibility that recklessness might satisfy the scienter requirement, the Supreme Court recognized that in certain instances a recklessness standard might be appropriate. *See Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1977) ("no hint in *Hochfelder* that the Court intended a radical departure from" common law analogue of fraud which imposes liability for reckless behavior), *cert. denied*, —— U.S. ——, 98 S.Ct. 225, 54 L.Ed.2d 155 (1977). The relationship most logically subjected to a recklessness standard, rather than

7. The requirement of scienter has been the rule in this circuit for some time. *See Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc); Sonde & Freedman, *"Seagulls on the Water—Some Ships in a Storm": A Comment on Lanza* v. *Drexel*, 49 N.Y.U.L.Rev. 270 (1974).

8. *Hochfelder* was pursued on an aiding and abetting theory.

9. We need not reach the question whether recklessness satisfies the scienter requirement where the alleged aider and abettor owes no duty of disclosure and of loyalty to the defrauded party. *See Hirsch* v. *duPont*, 553 F.2d 750, 759 (2d Cir. 1977).

some stricter standard involving proof of intent to defraud, is where the aider and abettor owes a direct fiduciary duty to the defrauded party. *See Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975). Liability premised on the recklessness of one's fiduciary in failing to perform his duty to disclose is a far cry from awarding damages for simple negligence. *See Ernst & Ernst* v. *Hochfelder*, *supra*. Clearly, Stott, as Rolf's broker, owed Rolf a fiduciary duty. *See Hanly* v. *SEC*, 415 F.2d 589, 596, 597 (2d Cir. 1969).[10]

Second, on a linguistic level, the term scienter[11] is used by the Supreme Court to mean, in the disjunctive, "knowing or intentional misconduct." 425 U.S. at 197, 96 S.Ct. 1375.[12] Use of the word "knowing" implies conduct which

10. We reject Stott's argument that the trading authorization given to Yamada relieves Stott of any duty to Rolf and thus of any liability. Stott was still Rolf's broker, though not his investment advisor, and owed Rolf a duty of loyalty normally expected of brokers. In addition, in view of the finding that Stott undertook to oversee Yamada's actions, the question whether a trading authorization, by itself, would serve to relieve a broker-dealer of liability is not before us.

11. Scienter is the Latin word for "knowingly." *See Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 33 (2d Cir. 1976).

12. It has been suggested that other language in *Hochfelder* mandates the conclusion that recklessness will not satisfy the scienter requirement. That language states:

> Use of the word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.

425 U.S. at 199, 96 S.Ct. at 1384 (footnote omitted). However, at another point in the opinion, footnote 12 is appended to the language

(footnote continued on next page)

is somewhat less directed and focused than "intentional" activity which commonly is characterized by a specific mental state whose animus is to bring about a particular result, *see* W. Prosser, *Law of Torts* §107, at 700 (4th ed. 1971). "Knowing" is a word laden with common law connotations: at common law, reckless conduct is viewed as a form of knowing conduct. *Id.* at 701. For example, the common law requirement of scienter as an element of the tort of deceit or misrepresentation may be proved in a number of ways:

> There is of course no difficulty in finding the required intent to mislead where it appears that the speaker believes his statement to be false. Likewise, there is general agreement that it is present when the representation is made without any belief as to its truth, or with reckless disregard whether it be true or false.

"allegation of 'scienter'—intent to deceive, manipulate, or defraud." *Id.* at 193, 96 S.Ct. at 1381. Footnote 12 then recognizes that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." *Id.* at 194 n. 12, 96 S.Ct. at 1381.

The *Hochfelder* opinion also noted:

> Although the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent, we think the relevant portions of that history support our conclusion that §10(b) was addressed to practices that involve *some element of scienter* and cannot be read to impose liability *for negligent conduct alone.*

425 U.S. at 201, 96 S.Ct. at 1385 (emphasis added). The Court seems to have recognized that scienter is not a rigid concept encompassing only the definitive intent to accomplish a specific purpose. A less definitive mental state—recklessness—would seem to suffice in certain circumstances and does not run afoul of *Hochfelder's* admonition that liability not be imposed for "negligent conduct *alone.*" *Id. See generally,* Note, *Recklessness Under Section 10(b): Weathering the* Hochfelder *Storm,* 8 Rutgers Camden L.J. 325, 342-45 (1977).

Id. (footnotes omitted). It is unquestionable that the common law has served as an interpretive source of securities law concepts. *See Holdsworth* v. *Strong,* 545 F.2d 687, 693-94 (10th Cir. 1976), *cert. denied,* 430 U.S. 955, 97 S.Ct. 1600, 51 L.Ed.2d 805 (1977). The common law tort of fraud has adopted a recklessness standard as one means of satisfying the requisite intent element of that cause of action.[13] Similarly, securities law cases have recognized that recklessness may serve as a surrogate concept for willful fraud. Concurring in *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 868 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates* v. *SEC,* 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969), Judge Friendly noted the distinction between a "merely negligent misstatement" and "the kind of recklessness that is equivalent to willful fraud." *See* Haimoff, *Holmes Looks at* Hochfelder *and* 10b-5, 32 Bus.Law 147, 162 (1976).

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13. *See, e. g., Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 190, 174 N.E. 441, 449 (1931) ("negligence or blindness, even when not equivalent to fraud, is nonetheless evidence to sustain an inference of fraud. At least this is so *if the negligence is gross*") (emphasis added). If *Ultramares* left open the common-law door on the recklessness issue, *State Street Co.* v. *Ernst,* 278 N.Y. 104, 112, 15 N.E.2d 416, 418-19 (1938), closed it:

> Accountants, however, may be liable to third parties, even where there is lacking deliberate or active fraud. A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.

See Restatement (Second) of Torts §526(b), Comment at 60 (1965).

Third, it is consistent with, if not demanded by, precedent in this circuit[14] to hold that reckless conduct satisfies the scienter requirement. *See Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc); *Shemtob* v. *Shearson Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971); Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst* v. *Hochfelder*, 29 Stan.L.Rev. 213, 214 (1977). *Lanza* v. *Drexel, supra*, of course required scienter as an element of a 10b-5 cause of action prior to the Supreme Court's decision in *Hochfelder*. The *Lanza* test was stated in terms of "willful or *reckless* disregard for the truth," *id.* at 1306 (emphasis added), thereby recognizing that either intentional or reckless behavior is the predicate mental state for 10b-5 liability. The *Hochfelder* Court noted that a number of courts of appeals "have held that some type of scienter—*i.e.*, intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud—is necessary in such an action" and then cited *inter alia* our decision in *Lanza*, 425 U.S. at 194 n. 12, 96 S.Ct. at 1381. Thus, on balance, we consider that *Hochfelder* left intact our rule that recklessness is a form of scienter in appropriate circumstances.[15]

14. Other courts have held that a recklessness standard is consistent with *Hochfelder*. *See, e. g., Sanders* v. *John Nuveen & Co., Inc.*, 554 F.2d 790, 792 (7th Cir. 1977); *Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033, 1040, 1043-45 (7th Cir. 1977) (reckless nondisclosure), *cert. denied*, —— U.S. ——, 98 S.Ct. 225, 54 L.Ed.2d 155 (1977); *Bailey* v. *Meister Brau, Inc.*, 535 F.2d 982, 993-94 & n. 14 (7th Cir. 1976) (reckless disclosure); *Stern* v. *American Bankshares Corp.*, 429 F.Supp. 818, 825 (E.D. Wis. 1977); *McLean* v. *Alexander*, 420 F.Supp. 1057 (D.Del. 1976). But *see SEC* v. *American Realty Trust*, 429 F. Supp. 1148, 1171 & n.8 (E.D. Va. 1977) (recklessness does not satisfy *Hochfelder*).

A final basis for applying a recklessness standard in certain instances rests perhaps on the practical problem of proof in private enforcement under the securities laws. Proof of a defendant's knowledge or intent will often be inferential, *see* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy* in Pari Delicto, *Indemnification, and Contribution*, 120 U.Pa. L.Rev. 597, 635 (1972), and cases thus of necessity cast in terms of recklessness. To require in all types of 10b-5 cases that a factfinder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of action under §10(b).

2. *Other elements of aiding and abetting liability.* Given, then, that we find aider and abettor liability appropriate under §10(b) and given that we believe at the very least that fiduciaries have acted with scienter when they have been reckless, we pass to the other well-established elements of the aiding and abetting cause of action. The

15. A major purpose of the *Hochfelder* decision was to foreclose "liability for wholly faultless conduct where such conduct results in harm to investors." 425 U.S. at 198, 96 S.Ct. at 1383. Adoption of a recklessness standard in this case does not result in liability for "wholly faultless conduct" and thereby does not impede an important policy of §10(b) and Rule 10b-15 as recognized in *Hochfelder*. *Hochfelder* itself found that "[t]here is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith. The catchall provision of §10(b) should be interpreted no more broadly." 425 U.S. at 206, 96 S.Ct. at 1387, Reckless behavior hardly constitutes good faith. Since good faith does not constitute a defense to reckless or intentional conduct, a recklessness standard is fully consistent with *Hochfelder* on its own terms. *See McLean* v. *Alexander, supra*, 420 F.Supp. at 1081.

first element that a plaintiff must prove is that the primary party, here Yamada, as distinguished from the secondary aiding and abetting party, committed a securities law violation. *Woodward* v. *Metro Bank of Dallas, supra,* 522 F.2d at 95; *see SEC* v. *Coffey,* 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied,* 420 U.S. 908, 95 S.Ct. 826, 42 L.Ed.2d 837 (1975); *cf. Landy* v. *Federal Deposit Insurance Corp.,* 486 F.2d 139, 162 (3d Cir. 1973) (requiring "independent wrong" instead of independent securities law violation), *cert. denied,* 416 U.S. 960, 94 S.Ct. 1979, 40 L.Ed.2d 312 (1974). The district court found, and we see no basis for concluding otherwise, that Yamada's overall management of the account in violation of his fiduciary duties owed by reason of the investment advisory agreement was fraudulent. 424 F.Supp. at 1043. Indeed the district court called Yamada's handling of the account a "gross fraud." *Id.* Moreover, Stott and BEDCO in their brief acknowledge that Yamada committed securities fraud. Their very purpose is to point the finger at Yamada in order to exonerate Stott. Brief for Defendants-Appellees-Cross-Appellants at 28, 34, 42, 44, 47. There is therefore no reason to analyze Rolf's portfolio on a stock by stock basis to determine which purchases and sales constituted frauds upon Rolf, a more specific and particularized investigation which we might have to undertake if Yamada had merely manipulated two or three stocks without engaging in a more exhaustive and all-encompassing web of fraud.

The second requirement for establishing the aiding and abetting violation is Stott's knowledge of Yamada's fraud. We have indicated above that the scienter element may be

satisfied by proof of reckless conduct. While the evidence in this case is not overwhelming, we believe it is sufficient to sustain Judge Pierce's findings on the basis of the clearly erroneous rule.

Reckless conduct is, at the least, conduct which is "highly unreasonable" and which represents "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Sanders* v. *John Nuveen & Co.,* 554 F.2d 790, 793 (7th Cir. 1977).[16] Stott was aware that the quality of the securities being purchased by Yamada was very low. The daily contact between Stott and Yamada gave Stott ample opportunity to supervise the investment advisor, an obligation which the lower court found Rolf had sought and Stott had undertaken to perform. Stott's most egregious breach of his duty to Rolf was his constant reassurance that Yamada knew what he was doing and that if Yamada were purchasing stocks they must be satisfactory. These representations were conclusorily made to Rolf without investigation and with utter disregard for whether there was a basis for the assertions. "A representation certified as true . . . when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability." *State Street*

16. For purposes of this decision we need not determine whether Stott's conduct would qualify as reckless under a less strict test as set forth in, *e.g., Stern* v. *American Bankshares Corp., supra,* 429 F.Supp. at 827 ("plaintiff must allege . . . that the defendants knew or *should have known* of the facts and circumstances concerning the fraud") (emphasis added).

Co. v. *Ernst*, 278 N.Y. 104, 112, 15 N.E.2d 416, 418-19 (1938). Stott's representations and opinions were given without basis and in reckless disregard for their truth or falsity.

The third and final requirement to establish the aiding and abetting violation is that Stott rendered substantial assistance to Yamada in the fraudulent mismanagement of Rolf's portfolio. One commentator has suggested that substantial assistance might include "repeating . . . misrepresentations (or aiding in their preparation), by acting as conduits to accumulate or distribute securities, by executing transactions or investing proceeds, or perhaps by financing transactions." 2 A. Bromberg, *Securities Law* §8.5 (515) (1974). In this case, Stott's assistance was both active and passive. He processed many of the relevant securities orders; he reassured Rolf of Yamada's competence; and he either recklessly failed to learn of or failed to disclose Yamada's web of fraud. *See Woodward* v. *Metro Bank of Dallas, supra*, 522 F.2d at 96-97. The effect of Stott's "hand-holding operation" was to prevent Rolf from discovering Yamada's fraud. Stott's acts, therefore, were a substantial causal factor in the perpetuation of Yamada's fraud and in the cumulation of Rolf's losses. *See Landy* v. *Federal Deposit Insurance Corp., supra*, 486 F.2d at 163. We therefore affirm the trial court's judgment to the extent that it found Stott an aider and abettor of Yamada's fraud.[16a]

16A. This decision does not impose liability on a broker-dealer who merely executes orders for "unsuitable" securities made by an investment advisor vested with sole discretionary authority to control the account. In the present case, the broker-dealer, although charged with supervisory authority over the advisor and aware that the advisor was purchasing "junk," actively lulled the investor by expressing confidence in the advisor without bothering to investigate whether these assurances were well-founded.

B. BEDCO

While there is disagreement among the circuits[17] and, perhaps, even disharmony within the Second Circuit[18] on the relationship between §20(a) of the 1934 Act, 15 U.S.C. §78t(a), and the common law doctrine of respondeat superior, BEDCO has conceded "for the purposes of this appeal" that if Stott is found liable it is vicariously liable under Section 20, even though the decision below stated that "BEDCO did not have actual notice of the fraud."[19]

17. *Compare Hollaway* v. *Howerdd*, 536 F.2d 690, 694-95 (6th Cir. 1976) (§20(a) has not supplanted doctrine of respondeat superior); *Fey* v. *Walston & Co.*, 493 F.2d 1036, 1051-52 (7th Cir. 1974) (same), *with Zweig* v. *Hearst Corp.*, 521 F.2d 1129, 1132-33 (9th Cir.) (§20(a) has supplanted doctrine of respondeat superior), *cert. denied*, 423 U.S. 1025, 96 S.Ct. 469, 46 L.Ed.2d 399 (1975). A similar difference of opinion exists with respect to the analogous "controlling persons" liability provision, §15 of the 1933 Act, 15 U.S.C. §77o. *Compare Johns Hopkins University* v. *Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970) (respondeat superior not supplanted by §15), *cert. denied*, 416 U.S. 916, 94 S.Ct. 1622, 40 L.Ed.2d 118 (1974); *Armstrong, Jones & Co.* v. *SEC*, 421 F.2d 359, 362 (6th Cir.) (same), *cert. denied*, 398 U.S. 958, 90 S.Ct. 2172, 26 L.Ed.2d 543 (1970), *with Kamen & Co.* v. *Paul H. Aschker & Co.*, 382 F.2d 689, 697 (9th Cir. 1967), *cert. granted*, 390 U.S. 942, 88 S.Ct. 1021, 19 L.Ed.2d 1129 *cert. dismissed*, 393 U.S. 801, 89 S.Ct. 40, 21 L.Ed. 2d 85 (1968) (discussion of derivative liability for securities violations solely by virtue of §§15 and 20(a) after conclusion of no liability under agency principles with respect to common law counts).

18. *Compare SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975), *with SEC* v. *Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976).

19. This permits us to avoid resolution of the rather thorny controlling person-respondeat superior issue as well as to leave for another day resolution of the even thornier issue of liability under NYSE or NASD rules, note 6 *supra*.

V
Damages

We are not capable of precisely measuring Rolf's damages on this appeal, although we do not think that they were so speculative as to compel resort solely to damages as in a churning case, for commissions paid the broker (and interest thereon). Accordingly, we remand to the district court to determine damages in accordance with the guidelines set forth below.

First, the district court should determine as near as possible the time when Stott began to aid and abet Yamada's fraud[20] and compute the market value of Rolf's portfolio on that date. Second, the district court should subtract the value of the portfolio on the date when Stott's participation in and assistance to the fraudulent scheme ceased from the value on the date when Stott became an aider and abettor. This amount is Rolf's gross economic loss.[21] *See* Note, *Churning by Securities Dealers*, 80 Harv. L.Rev. 869, 884 (1967). The district court should then reduce Rolf's gross economic loss by the average percentage decline in value of the Dow Jones Industrials, the Standard & Poor's Index, or any other well recognized index of value, or combination of indices, of the national securities markets during the period commencing with Stott's aiding and abetting and terminating with its cessation.[22] Thus if during the relevant period the stock

20. Of course Stott's liability is predicated on his contractual involvement in the management of Rolf's account, representing as he did one-half of the "Stirling-type operation." But Stott may not have been an aider and abettor from the moment Rolf executed the trading authorization to Yamada. That will depend on the district court's view of Stott's conduct in light of the three-part test of aiding and abetting liability discussed above.

21. What we have referred to as Rolf's gross economic loss on a portfolio-wide basis during a relevant period of time is often referred to as a rescission measure of damages. 3 A. Bromberg, *supra* at 9.1; *see Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167, 1173 (2d Cir. 1970). This case is, however, somewhat different from the typical rescission situation as in *Chasins*. Here Stott's participation in Yamada's fraud infected Rolf's portfolio during a specific period of time to be determined on remand. In a sense the portfolio will be deemed sold as of the last day of the aiding and abetting period in order to determine what the resale price would have been if the portfolio had been liquidated on that day. *See generally* Mullaney *Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability*, 46 Fordham L.Rev. 277, 284-85 (1977).

22. Rolf's portfolio, even if it had not been fraudulently mismanaged, would have declined in value during the bear market of the aiding and abetting period. Stott and BEDCO have no responsibility for the general decline in economic conditions. The rescission theory of damages which we essentially utilize here cannot restore a plaintiff to a *better* position than he would have been in if the fraud had not occurred. *See generally Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1304-06 (2d Cir. 1973); *3 A. Bromberg, supra at* 9.1 & n.2 SEA §28(a), 15 U.S.C. §78bb(a), limits recovery to "actual damages."

Some courts, albeit in different securities law contexts, have used technical computations to limit recoveries to actual damages. *See Mills* v. *Electric Auto-Lite Co.*, 552 F.2d 1239, 1248 (7th Cir. 1977) (technical damages formula to measure fairness of merger), *cert. denied*, —— U.S. ——, 98 S.Ct. 398, 54 L.Ed.2d 279 (1977) (No. 77-331); *Bonime* v. *Doyle*, 416 F.Supp. 1372, 1377, 1386 (S.D.N.Y. 1976) (factoring out of damages computation "losses attributable to 'unique characteristics of a particular . . . .'" by using two indices composed of stocks of comparable value to the stock at issue); *Feit* v. *Leasco Data Processing Equipment Corp.*, 332 F.Supp. 544, 586 (E.D.N.Y. 1971) (reducing trading losses by decline in the Standard & Poor's Daily Stock Price Index). *Feit* has been criticized for utilizing a "broad-based index" without considering whether the index as a whole was similar in nature to the security under consideration. *Reder, Measuring Buyers' Damages in* 10b-5 *Cases*, 31 Bus. Law. 1839, 1850 (1976). Here, of course, Rolf's portfolio consisted of numerous stocks. At the outset of Yamada's stewardship, they were of generally high quality. If the district judge should determine that, when the aiding and abetting period began, the quality of stocks in the portfolio was such that a broad-based index would not be representative of those stocks, then he may select a more appropriate gauge, perhaps a portion of an index, perhaps a composite of indices, perhaps expert opinion. *See generally*, Mullaney, *supra* note 21, at 288-90.

market declined in value by 25%, then Rolf's gross economic loss should be reduced by 25%. Because plaintiff's theory of liability is to the effect that Stott's aiding and abetting prevented Rolf's discovery of Yamada's fraud, it is not fair to reduce damages any further by the amount of loss on a discrete transaction to which Stott had no connection because he did not execute the transaction, recommend the security, or reassure Rolf with respect to that security.[23] However, should the loss on the Delanair stock be determined to have occurred during the aiding and abetting period, Rolf's damages must be reduced by $175,000, the amount for which he settled his claims against several Delanair-related defendants. We also hold that Rolf is entitled to a return of commissions paid to Stott and BEDCO, but only as to transactions falling within the aiding and abetting period, with interest thereon as determined by the district judge.

Finally, we request the district judge to reconsider his decision on the question of prejudgment interest in view of our obvious conclusion that Rolf was deprived of a principal sum. *See Nelson* v. *Hench,* 428 F.Supp. 411 (D.Minn.1977). While such an award is a matter of judicial discretion, *Blau* v. *Lehman,* 368 U.S. 403, 414, 82 S.Ct. 451, 7 L.Ed.2d 403 (1962); *Norte & Co.* v. *Huffines,* 416 F.2d 1189, 1191-92 (2d Cir. 1969), *cert. denied sub nom. Muscat* v. *Norte & Co.,* 397 U.S. 989, 90 S.Ct. 1121, 25 L.Ed. 2d 396 (1970), it is not unreasonable to request the district

23. Rolf, for example, may not collect damages for losses in accounts opened at other brokerage houses where those accounts were managed by himself and not Yamada or without Stott's participation or knowledge.

judge to set forth his reasons should he again deny prejudgment interest. *See Wessel* v. *Buhler,* 437 F.2d 279, 284 (9th Cir. 1971).

Judgment affirmed in part and remanded.

MANSFIELD, Circuit Judge (dissenting):

I must respectfully dissent.

The majority holds a registered representative (Stott) and his employer (BEDCO) liable under §10(b) and Rule 10b-5 to their customer (Rolf) for losses suffered by the customer upon purchases and sales of securities executed at the direction of Rolf's own independent investment adviser (Yamada) pursuant to written discretionary authority from Rolf instructing Stott and BEDCO to follow Yamada's orders. This result is achieved on the grounds that (1) the investment advisor (Yamada) was committing various frauds on the customer (Rolf), and (2) the broker (Stott), although he knew nothing of the frauds, "aided and abetted" Yamada's conversion of Rolf's account to unsuitable securities by "holding the hand" of Rolf pursuant to an oral agreement to "look after" Rolf's account and by assuring him of Yamada's competence as an investment counsel.

The majority views Yamada's investment of the account in unsuitable securities as fraud in and of itself and Stott's state of mind as recklessness amounting to a deliberate intent to deceive. All of this is too much for me to accept. The majority not only patches together watered-down notions of fraud and scienter in arriving at a result indistinguishable in any significant respect from that reversed

by the Supreme Court in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), but also overlooks findings below and undisputed evidence that foreclose Rule 10b-5 liability.

With regard to the "fraud" by Yamada that Stott is held to have aided and abetted, Judge Pierce found, and the majority here seems to agree, that "Stott did not know of the direct frauds which Yamada was perpetrating on Rolf" —such as the investment adviser's manipulation of the public market price of certain securities obtained for Rolf's account and the use of the purchasing power of that account to make purchases of securities that might improve the price for others. Nor is there any basis for a finding that Stott shut his eyes to any such manipulation or use of Rolf's account to help others. Indeed, it is undisputed that at all pertinent times Yamada's reputation as an investment adviser was excellent and his successful accomplishments in the trade were well known. Even on the majority's "aiding and abetting" theory, therefore, Stott could not be held responsible for Yamada's manipulations, since they were not known to Stott and would not have been readily apparent upon exercise of due diligence, including compliance with New York Stock Exchange Rule 405 ("know your customer" rule).

Because even the majority concedes that "Stott was ignorant" of Yamada's "stock manipulations," it becomes important to determine what was the fraud "aided and abetted" by Stott through some "reckless disregard" on his part. The majority opinion, making precious little mention of any frauds committed by Yamada, fails completely to describe or analyze the specific fraud or frauds

that were furthered by Stott other than to suggest that they were "Yamada's investment decisions" and his conversion of Dr. Rolf's portfolio into securities that were highly speculative and of very low quality compared with the type of securities that had been there when the account had been managed directly by Mr. Stirling of BEDCO. What the district court labelled "tantamount to fraud"—Yamada's investment of Rolf's account in unsuitable securities, so-called "high fliers," "junk," or "low quality" issues--is characterized by the majority in conclusory fashion as part of "a more exhaustive and all-encompassing web of fraud." The majority's forbidding label cannot alter the fact that, when this case is stripped of the brooding omnipresence of Yamada's flagrant manipulations as it must be, nothing remains but an unfocused allegation that Stott lulled Rolf into acquiescence in Yamada's investment of his account in unsuitable securities. To hold that he thereby aided and abetted a Rule 10b-5 "fraud" is to confuse the common law duties of fiduciaries or accountants, see, e. g., *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 190, 174 N.E. 441, 449 (1931), with the limited prohibitions of §10(b) and Rule 10b-5 against the use of any "manipulative or deceptive device or contrivance" in the purchase or sale of securities.

Even assuming *arguendo* that the investment of a customer's funds in unsuitable securities could on occasion rise to the level of Rule 10b-5 fraud, the majority errs in concluding that Stott's conduct, principally his assurances regarding Yamada's competency as investment counsel, coupled with Stott's personal belief that some of the investments were "junk," establishes recklessness equivalent to an intentional and deliberate participation in or aiding

and abetting of such "fraud." In my view this determination violates fundamental principles established by the Supreme Court in *Ernst & Ernst* v. *Hochfelder,* supra, and stems from an erroneous concept of "recklessness" or "reckless disregard" of material facts.

In *Hochfelder* the Court reversed a decision of the Seventh Circuit which had held "that one who breaches a duty of inquiry and disclosure owed another is liable in damages for *aiding and abetting* a third party's violation of Rule 10b-5 if the fraud would have been discovered or prevented but for the breach. 503 F.2d 1100 (1974)." 425 U.S. at 191, 96 S.Ct. at 1380 (emphasis added). The Supreme Court held that proof of scienter, i. e., an "intent to deceive, manipulate or defraud," was essential and that this element was not satisfied by proof of negligence or breach of a duty to inquire. It left open the "question whether, in some circumstances, reckless behavior" might be treated as the equivalent of scienter, 425 U.S. at 194 n. 12, 96 S.Ct. at 1381.

While *Hochfelder* did not clarify entirely the meaning of scienter, it did make clear that the failure of a fiduciary or accountant to fulfill a "common-law and statutory duty of inquiry," 425 U.S. at 192, 96 S.Ct. at 1380, which would reveal fraud on someone else's part, is not without more the equivalent of scienter as defined by the Court. Since *Hochfelder* we have reiterated that

> ". . . before [a party] can be held liable as an aider and abetter, there must be a showing that [such a party]: (a) knew of the investment adviser-client relationship; (b) had knowledge of the fraud; and (c) acted in concert with the investment adviser. Cf. *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 [96 S.Ct. 1375, 47 L.Ed.2d 668] (1976)." *Abrahamson* v. *Fleschner,* 568 F.2d 862, at 871-872 n. 16 (2d Cir. 1977).

See also *Hirsch* v. *du Pont,* 553 F.2d 750, 759 (2d Cir. 1977) ("knowing assistance of or participation in a fraudulent scheme gives rise to liability under §10(b) as an aider and abettor. . . . knowledge of the fraud . . . is indispensable"); *Kerbs* v. *Fall River Indus., Inc.,* 502 F.2d 731, 739-40 (10th Cir. 1974); *SEC* v. *Coffey,* 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied,* 420 U.S. 908, 95 S.Ct. 826, 42 L.Ed.2d 837 (1975). Accordingly, in my view, before "reckless disregard" may be equated to scienter, there must be a showing that the party charged with violation of Rule 10b-5 deliberately shut his eyes to the obvious, such as material facts that would be patent upon a mere cursory examination or review.[1] Failure to conduct an investigation—even if required by one's status as a fiduciary—will not suffice.

Judged by this standard, the facts as stated by the majority fail to support a conclusion that Stott participated in any fraud with the scienter required by *Hochfelder.* As proof that Stott "rendered substantial assistance to Yamada in [his fraud]," the majority relies upon Stott's processing of Yamada's securities orders given pursuant

1. The cases cited by the majority do not warrant the recognition of any more inclusive definition of scienter. See, e.g., *Lanza* v. *Drexel & Co.,* 479 F.2d 1277, 1306 & n. 98 (2d Cir. 1973) (en banc) (judgment for defendant affirmed; no showing that he "willfully closed his eyes to or turned his back" on the fraud; material failure to disclose must be apparent "without any extraordinary effort."); *Sanders* v. *John Nuveen & Co.,* 554 F.2d 790, 793 (7th Cir. 1977) (no finding that "danger was either known to the defendant or so obvious that the defendant must have been aware of it").

to his discretionary authorization from Rolf, Stott's representations to Rolf to the effect that Rolf could depend on his adviser's judgment, and Stott's failure to disclose Yamada's fraud (i. e., the purchase of low-grade securities). However, the majority is vague as to how any of this conduct can be said to have been undertaken with the "reckless disregard" that must be treated as the equivalent of knowledge of Yamada's fraud. Apparently, the theory of the majority opinion is that Stott's continuing expressions of confidence in Yamada and his willingness to accept the adviser's orders were reckless in view of his "[awareness] that the quality of the securities being purchased by Yamada was very low." The opinion describes Stott's reassurances regarding Rolf's reliability as having been made "conclusorily . . . without investigation and with utter disregard for whether there was a basis for the assertions." Likewise, it states that Stott "either recklessly failed to learn of or failed to disclose Yamada's web of fraud"—again referring only to the purchase of unsuitable securities. However, even conceding that Stott believed some or many of Yamada's purchases to be "junk," it would have required a considerable investigation for him to determine whether Yamada's widely-recognized reputation for brilliance was unwarranted or whether the ratio of risk to return on Rolf's portfolio as a whole was consonant with the doctor's investment objectives. A failure to perform such an investigation without more does not, after *Hochfelder*, establish scienter.

Sympathetic as I am to vigorous enforcement of the antifraud provisions of our federal securities laws, I cannot subscribe to a process of extrapolation, approved by

the majority opinion, whereby Yamada's investment of Rolf's account in unsuitable securities is elevated to the level of Rule 10b-5 fraud and Stott's personal belief that some of the investments were "junk" is recognized as a sufficient basis for concluding that he acted with scienter. Reasoning along these lines, the majority has ended up with a holding that is virtually indistinguishable from that reversed in *Hochfelder*. A broker (Stott) is held liable under Rule 10b-5 for negligence in failing to make an adequate inquiry into the investments recommended by the plaintiff's investment adviser (Yamada), who turned out to be dishonest even though widely acclaimed as a competent and successful investment adviser at the time. In short, stripped of its conclusory characterizations, the majority opinion would barely make out a case of negligence on the part of Stott, much less one of his deliberately shutting his eyes to facts that would have revealed the "fraud" on Yamada's part. When additional lower court findings and undisputed evidence, unmentioned or glossed over by the majority, are taken into account, the failure to make out a case of "fraud" based on unsuitable investments or aiding and abetting of that fraud by recklessness becomes apparent. In the first place, Dr. Rolf was no novice or "babe in the woods" in the investment field. He had had 19 years of experience, including 10 years completely on his own, during which he was his own adviser and the supervisor of various trading accounts maintained by him with several different Cleveland brokers. Having tasted success in the predominantly bull market of the 1950s and 1960s, Rolf had advised Stirling of BEDCO as early as June, 1967, that his "objective [was]

to d uble my equity'' and told Yamada as late as September 1970 (after the value of his portfolio had greatly declined, principally because of investments made by Yamada), ''As you recall, we started out with roughly $2,000,000 of Securities which could be used for trading. . . . It was my impression that we would wind up with 3.5 to 5 million in a year's time.''

The picture that emerges from these and other statements made by Rolf is one of a sophisticated investor in securities who was well aware of the difference between gilt-edge, relatively safe securities, on the one hand, and speculative ''high fliers,'' on the other, and who had determined to get richer quick by choosing an aggressive program involving high-risk, OTC stocks in the hope that his adviser would succeed in picking a few big winners, but well aware of the pitfalls that were involved.[2]

From this record it is small wonder that when introduced by Stott to a couple of prospective investment advisers, whom he personally interviewed, he chose 26-year old Yamada, ''one of the 'new breed' of young money-managers who had emerged as highly successful in the stock market'' during the late 1960s by dealing in special situations, mutual funds, new issues, hedge funds and assorted speculative ventures.[3] Rolf's correspondence discloses that he could hardly be classified as a naive, trusting person of limited intelligence looking for safe investments designed to yield substantial income and security. Rolf testified that he ''wanted somebody other than Stott'' to handle his account. In short, he *wanted* to gamble on some ''high fliers'' and for this he looked to Yamada, not Stott. Indeed, Rolf never even met Stott in person until October, 1970, some 17 months after Rolf had selected Yamada as his investment adviser. By that time Rolf's portfolio had declined in market value from $1,423,000 to approximately $223,000.

The tenuousness of holding Stott liable as an aider and abettor is further underscored by the anomalous nature of his responsibilities toward Rolf, once Rolf had chosen Yamada rather than BEDCO to advise him as to his investments. The oral Rolf-Stott arrangement, according to Judge Pierce's findings, was that while Yamada alone would have discretionary responsibility with respect to what was to be bought and sold for Rolf's account, Stott would ''supervise his [Rolf's] account and Rolf understood that Stott was to look after his interests.'' In such a context the role of overseer, in the absence of some fixed written delineation of authority and responsibility, borders on the meaningless.[4] It is an elementary market fact, which

2. Judge Pierce found Rolf to be a "sophisticated" investor, willing to take "substantial risks" and "to engage in extensive trading," who "wanted a very aggressive investment program" and "kept careful watch over his securities," verifying current market prices frequently and employing a bookkeeper to follow his investments.

3. Rolf and Yamada both testified that from the outset of their relationship it was agreed that in an effort to obtain a greater capital gain on Rolf's investments than he was presently able to realize Yamada would be making changes in Rolf's portfolio.

4. The weakness inherent in attempting to predicate liability on Stott's telephonic agreement to "look after" Rolf's account is underscored by Rolf's maintenance of accounts with at least seven brokerage concerns other than BEDCO, through which purchases and sales were executed, some on Yamada's advice, at a net loss of $133,229, without the knowledge or participation of Stott or BEDCO. The other concerns included Lynch, Jones & Ryan; Kordich, Victor & Neufeld; Woodcock, Moyer, Fricke & French; Provident Securities; Bearwald & DeBoer; Amswiss International; and Laird Incorporated. Although it seems that Stott often received notice of transactions conducted through firms other than BEDCO, he was hardly in a position to influence specific purchases or sales.

should be judicially noticeable, that since there are literally thousands of business ventures traded on various exchanges in the United States, it is impossible for any one investment adviser or brokerage concern to follow all traded business ventures closely or to maintain suffiicent information with respect to each and every one to furnish an informed expert opinion with respect to its prospects as an investment. As a result, each investment adviser and group of security analysts on the staff of a broker or investment banking concern usually limits itself to in-depth study of a fraction of the entire gamut, maintaining a detailed analysis of each company in the selected group, based on studies of every available bit of information about it, including visits to and conferences with its top personnel, customers and others. Although an adviser or brokerage house may have expertise with respect to companies within its selected group, it would have much less knowledge, or even none, about hundreds of other traded companies unless it undertook a special study.

If Rolf had looked to Stott and BEDCO for investment counsel, as he had to Stirling, Stott would undoubtedly have learned more about Rolf's investment objectives and maintained for him a portfolio of securities with which BEDCO's experts were intimately familiar. As it was, Stott was justified in relying upon Yamada's expertise with respect to the securities recommended by him. Although Stott may have personally thought that some of the latter were "junk" or "high fliers" it must be remembered, first, that Yamada then enjoyed an excellent reputation as a successful adviser. Once a student at the Harvard Busi-

ness School, he had risen rapidly to the position of officer in the investment banking firm of Kuhn Loeb & Co., described by Judge Pierce "as a conservative and prestigious firm which generally handled 'triple-A' clients," where Yamada developed "expertise in research and 'special situations'." Yamada had then left Kuhn Loeb to form a partnership with others, including Keither [sic] Funston, former President of the New York Stack Exchange, John Burns, former President of RCA and Chairman of the Board of Cities Service, and J. Richardson Dilworth, head of the Rockefeller Brothers Fund. Yamada was well known in the securities field, managed approximately $20 million for customers and was in daily consultation with numerous securities firms. Rolf himself, an experienced trader on his own behalf, after personally interviewing Yamada was favorably impressed by him as "very brilliant and capable."

In short, although Rolf later testified, after Yamada's advice had proved disastrous, that he had "expected BEDCO to *look after* his account," (emphasis added), Rolf never put this in writing or defined precisely what was to be BEDCO's area of responsibility other than to keep him advised as to what securities were being purchased and sold for the account. On the contrary, by letter dated May 9, 1969, to BEDCO Rolf directed, "You will kindly follow his [Yamada's] instructions in every respect concerning my account with you . . . as he may order and direct." Rolf had what amounted to a custody account with BEDCO. When it came to investment decisions, although Stott (whom Rolf had never met and hardly knew) made recom-

mendations to Yamada, it was clear that Yamada was in command.[5]

Against such a background, I fail to find any substantial basis for holding that Stott's assurances to Rolf, made long prior to the time when Yamada's fraud and manipulations became known, regarding Yamada's competence and Stott's expressions of opinion to the effect that if Yamada recommended certain investments they must be all right, constituted aiding and abetting of any fraud on Yamada's part.[6] Although Stott might have personally considered some of the investments made by Yamada to be unproved and hence "junk," it would have been foolhardy for him to voice such a view to Rolf, since Yamada, who was in command and had gained his reputation in part from his successful dealing in special situations, might well be possessed of detailed information not available to or obtained by BEDCO or Stott.

5. Rolf also appears to have made some investment decisions that may not have been shared even by Yamada, much less by Stott. For instance, in June 1969, Rolf operated a non-discretionary account with Hornblower & Weeks-Hemphill & Noyes, through which he purchased

American Scientific Corp.
Dasa Corp.
Data Network Mega Systems, Inc.
Ampex Corp.
Mohawk Data Science.

6. Moreover, the generality of Stott's conclusory assurances—"that Yamada knew what he was doing and that if Yamada were purchasing stocks they must be satisfactory"—must have made it readily apparent to Rolf from the outset that Stott was relying on Yamada's excellent reputation rather than on an investigation into the merits of each investment, conducted personally or through BEDCO's staff of analysts. Otherwise, he would have reported to Rolf on the results of his independent research. Yet Rolf never requested or received any such check-up, even though he was well aware from past experience of BEDCO's facilities.

Absent evidence to the contrary, we cannot assume that Stott's views were based on independent research, as distinguished from hunch. Some of the greatest gains and widest movements in traded securities have occurred in OTC stocks, of which astute advisers have taken advantage because of intensive private investigation revealing business prospects or probable takeovers not generally known. In this case, for instance, as Judge Pierce noted, "Yamada made fairly substantial profits for Rolf on short-term trading in six of the seven manipulated stocks" which he bought for Rolf in 1970. 424 F.Supp. at 1034.

An analysis of the securities issues purchased by Yamada for Rolf reveals that many of the investments, although they declined in market value when the bloom faded on the bull market, were concededly not unsuitable, that others were listed on major stock exchanges, and that some "unsuitable" issues turned out to be profitable. Of the 40-odd security issues purchased for Rolf's account which form the basis of his claim, the district court found that Stott had "either recommended or was somewhat involved with the decision to purchase the following twelve."[7] There

7. The 12 were:

Simplex Wire & Cable Co.
Teradyne, Inc.
Standard Oil of N. J.
Reading & Bates Offshore
Intertherm, Inc.
Food Fair Properties
International Funeral
Natomas Corp.
Asamera Oil Corp.
Carter Wallace, Inc.
West Coast Production
Equity Funding Corp.

is no evidence that any of these 12 were unsuitable for Rolf's account. Nor was there any testimony as to the suitability of certain other securities bought for Rolf.[8]

Under these undisputed circumstances, including Yamada's investment of a substantial portion of Rolf's account in apparently suitable securities, I cannot share the majority's conclusion that investment of the balance in securities labelled unsuitable by an expert witness amounts to fraud, much less that Stott's conduct aided and abetted such "fraud." I favor holding a broker to his duties under Rule 405, for violation of which remedies are provided by the New York Stock Exchange, N.Y.S.E. Constitution Art. VIII, Rules 481, *et seq.* (providing for arbitration of disputes between member firms and others) and §§6, 13 (authorizing suspension, expulsion, fines and censure), and an investment adviser for fraud in violation of the Investment Advisors Act, see *Abrahamson* v. *Fleschner*, 568 F.2d 862 (2d Cir. 1977). But to hold that investment of a customer's account in unsuitable securities constitutes §10(b) fraud and that a broker who executes orders given by an investment adviser pursuant to his discretionary authority may be held liable as an aider and abettor of such fraud, places an extraordinary and unconscionable burden on both the adviser and the broker.

8. These include:

Benquet Consolidated
City Investing
Consolidated Oil & Gas
Funeral Homes of America
Loews Theatres
Outlet Co.
Four Seasons Nursing Centers of America
U.S. Natural Resources
Milgo Electronic Corp.

Nor do I agree with the district court's view that an implied right of action for damages in favor of Rolf may be based on Stott's alleged violations of N.Y.S.E. Rule 405[9] or Article III, §2, of the Rules of Fair Practice of the National Association of Securities Dealers.[10] Accepting the premise that "the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation," *Colonial Realty Corp.* v. *Bache & Co.*, 358 F.2d 178, 182 (2d Cir.), *cert. denied*, 385 U.S. 817, 87 S.Ct. 40, 17 L.Ed.2d 56 (1966), we must also follow the guidelines established by the Supreme Court in *Cort* v. *Ash*, 422 U.S. 66, 78, 95 S.Ct. 2080, 45 L.Ed.2d 26 (1975), which require us to determine (1) whether the plaintiff is a member of the class for whose especial benefit the law was intended; (2) whether

9. Rule 405 provides in pertinent part:

"Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) to "(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization. [and to]

"(2) Supervise diligently all accounts handled by registered representatives of the organization."

10. Article III, §2, provides:

"In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

Congress expressed any preference for or against a remedy; (3) whether a private action would be consistent with the underlying purposes of the legislative scheme; and (4) whether the cause of action is one in an area traditionally relegated to state law.

Applying these guidelines, it is not at all clear that Rule 405 or Art. III, §2, were intended solely for the particular benefit of investors. Indeed, they appear designed as much to protect brokers from being victimized by unscrupulous customers. See *Landy* v. *FDIC*, 486 F.2d 139, 166 (3d Cir. 1973), *cert. denied*, 416 U.S. 960, 94 S.Ct. 1979, 40 L.Ed.2d 312 (1974). To imply a damages remedy based on nonfeasance or gross negligence would, moreover, run counter to the principles of *Hochfelder* and possibly inhibit the NYSE and NASD from promulgating additional standards for the guidance of their members. In short, NYSE and NASD rules are not the same for the purpose of implied remedies as SEC rules. See *Jenny* v. *Shearson, Hammill & Co.*, [1974-75 Transfer Binder] Fed.L.Sec.Rep. (CCH) ¶95,021, at 97,582 (S.D.N.Y.1975); *Plunkett* v. *Dominick & Dominick*, 414 F.Supp. 885 (D.Conn.1976). Lastly, whatever obligation might be imposed by rule on a broker dealing solely with his customer, the interposition of an investment adviser with the sole discretionary authority to determine what investments shall be made for the customer weighs against extending any liability of the broker that might otherwise be implied on the basis of a direct broker-customer relationship.

For these reasons, I would reverse the judgment of the district court and remand with directions to enter judgment in favor of the defendants dismissing the action.

APPENDIX B

Order Amending Opinion of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket Nos. 77-7104, 77-7124

DAVID E. ROLF,

Plaintiff-Appellant-Cross-Appellee,

v.

BLYTH, EASTMAN DILLON & CO., INC. and MICHAEL STOTT,

Defendants-Appellees-Cross-Appellants.

The opinion in the above entitled case is hereby amended by inserting Footnote 16A at the end of the first paragraph on slip opinion 905, after the word "fraud," said footnote reading as follows:

> 16A. This decision does not impose liability on a broker-dealer who merely executes orders for "unsuitable" securities made by an investment advisor vested with sole discretionary authority to control the account. In the present case, the broker-dealer, although charged with supervisory authority over the

advisor and aware that the advisor was purchasing "junk," actively lulled the investor by expressing confidence in the advisor without bothering to investigate whether these assurances were well-founded.

/s/ J. Joseph Smith

/s/ James L. Oakes

U. S. Circuit Judges

[seal]
United States Court of Appeals
FILED
MAY 22 1978
A. Daniel Fusaro, Clerk
SECOND CIRCUIT

APPENDIX C

Opinion and Order of the United States District Court for the Southern District of New York

UNITED STATES DISTRICT COURT

S. D. New York

No. 73 Civ. 2967

David E. Rolf,

Plaintiff,

v.

Blyth Eastman Dillon & Co., Inc., *et al.*,

Defendants.

Jan. 17, 1977

Sidney B. Silverman, Silverman & Harnes, New York City, for Plaintiff.

Thomas W. Kelly, Richard W. Lyon, Breed, Abbott & Morgan, New York City, for defendants Blyth Eastman Dillon Co. and Michael Stott.

Barry A. Tessler, New York City, for defendant Akiyoshi Yamada.

Pierce, District Judge.

This securities action brought by plaintiff David E. Rolf presents important questions concerning the duties and responsibilities of a broker dealer and its registered representative under circumstances in which their customer is being defrauded by his investment adviser. Unlike the

usual case brought under the federal securities laws, here it is clear that fraud and breach of fiduciary duty are present. The key questions in this case are whether the broker aided or participated in the fraud, and whether the broker and his employer took adequate steps to protect their customer against the investment adviser who traded plaintiff's account pursuant to a power of attorney.

The matter was tried before the Court without a jury for nine days in June and July 1976. The allegations of the complaint are as follows.

Plaintiff David Rolf's complaint seeks to hold defendants liable in damages for alleged violations of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, which prohibits securities fraud by any person through the instrumentalities of interstate commerce or of any facility of any national securities exchange. Also claimed are violations of Section 15(c)(1) of the Exchange Act, and Rule 15cl-2, which similarly prohibit securities fraud by broker dealers in the over-the-counter markets. Plaintiff also alleges violations of Section 15A of the Exchange Act, dealing with registration and regulation of broker dealer associations, and of Article III, Section 2 of the Rules of Fair Practice adopted by the National Association of Securities Dealers, Inc. ("NASD") promulgated thereunder, the latter requiring suitability of securities recommended by brokers for investors. Finally, plaintiff asserts violations of Rule 405(1) and (2) of the New York Stock Exchange ("NYSE"), which require due diligence and diligent supervision in the management of securities accounts handled by registered representatives.

This Court has jurisdiction over this action brought to enforce liabilities and duties created under the Exchange Act and by the rules and regulations promulgated thereunder pursuant to 15 U.S.C. §78aa.

In brief, plaintiff claims that the defendants churned his account, that they severely altered the nature of his securities portfolio by placing unsuitable securities therein, that they failed to properly supervise his account, and that they aided and abetted each other in these alleged violations. In sum, plaintiff claims that the defendants took an account worth $1,423,000 in May of 1969 and returned to him in January of 1971 an account worth only $225,000 as a result of their fraud. For damages, plaintiff seeks, inter alia, a return of commissions and interest; an award equal to the net trading losses claimed; and, although the complaint states no cause of action under state law, punitive damages of one million dollars.

At the trial of this action, plaintiff abandoned all claims made against his investment adviser, defendant Akiyoshi Yamada, in exchange for Yamada's testimony against the remaining defendants (see PX-19). Defendants Blyth Eastman Dillon & Co. ("BEDCO") and its registered representative Michael Stott assert that they are not liable because plaintiff has not proved his claims, because Yamada and not the other defendants controlled plaintiff's account, and because they breached no duty owed to the plaintiff. In their answer defendants BEDCO and Stott assert cross-claims against Yamada for indemnity.

Having heard all the evidence and having considered the matter, the Court dismisses plaintiff's churning claim,

but finds defendants BEDCO and Stott liable for violations of the NYSE and NASD rules, which violations involved breach of defendants' fiduciary duties tantamount to fraud. The Court also finds defendant Stott liable for aiding and abetting Yamada in the fraud which the investment adviser perpetrated upon plaintiff in violation of Rule 10b-5 and through breach of his own fiduciary duties. The following shall constitute the Court's findings of fact and conclusions of law pursuant to Rule 52(a) Fed.R.Civ.P.

The Parties

Plaintiff David E. Rolf is a physician, surgeon and ophthalmologist, residing in Shaker Heights, Ohio. Dr. Rolf has practiced medicine since 1936, and at the time of trial he was sixty-eight years old. Rolf began investing his earnings in the stock market in 1950, and by 1962 his portfolio was worth approximately $400,000. Plaintiff testified that he works long hours at the hospital, and that he is on twenty-four hour call. During the period 1950 through 1962, plaintiff retained several different Cleveland brokers, switching firms often because he felt that the brokers were not sufficiently knowledgeable and that they did not have his interests at heart. During this period plaintiff maintained non-discretionary accounts, making his own decisions with respect to transactions in securities. Rolf was an active follower of the stock market, primarily through the Wall Street Journal. Prior to his first contact with BEDCO in 1963, plaintiff had maintained accounts at Merrill Lynch, Pierce, Fenner & Smith, Inc., Paine Webber & Co., Hartzmark & Co., Prescott & Co., Bache & Co., and finally, at Walston & Co. where Rolf first engaged an investment adviser with discretionary authority over

his securities. Rolf stated that during this period his investment objective was capital growth first and security second. Plaintiff testified that he switched to discretionary accounts in 1962 because he was too busy with medicine to be in constant consultation with brokers, and because he felt his portfolio was too large for him to handle.

In 1963, plaintiff took his securities to Eastman Dillon Union Securities & Co., and entrusted their management to S. Logan Stirling, a partner and a prominent investment adviser associated with that firm and with defendant BEDCO, the successor corporation to Eastman Dillon Union Securities & Co. BEDCO was at all relevant times a registered broker dealer and a member of the New York Stock Exchange and the National Association of Securities Dealers. During the relevant period, BEDCO engaged in corporate and municipal underwritings, maintained a large research department, and employed a substantial retail sales force. BEDCO dealt in listed and over-the-counter securities for individual clients and as a market-maker (Tr. 1005).

While Dr. Rolf did not come into contact with BEDCO's Michael Stott until 1969, Stott had been a registered representative with that firm since 1958, and in 1963 Stott was branch manager of BEDCO's Paterson, New Jersey, office. Later Stott became branch manager of BEDCO's Newark office; at each branch office one of his primary responsibilities was supervision of the registered representatives (Tr. 757). In the fall of 1967 Stott returned to BEDCO's New York office as a registered representative. By 1969, Stott was handling approximately 150 individual and institutional accounts at BEDCO, earning one-third of all

commissions on the securities he traded (Tr. 914-15). That year Stott first met a young and ambitious investment adviser Akiyoshi Yamada.

Yamada, the son of a wealthy Japanese industrialist, had attended Harvard Business School for one year prior to 1965 when he joined the investment banking firm of Kuhn Loeb & Co. (Tr. 557). Yamada described Kuhn Loeb as a conservative and prestigious firm which generally handled "triple-A" clients (Tr. 509). At Kuhn Loeb, Yamada eventually became an officer of the firm purportedly with expertise in research and "special situations". In 1969, at the age of 26, Yamada left Kuhn Loeb to form an investment partnership; during the period of the complaint he was not associated with any research firm or brokerage house (Tr. 558).

Yamada was described at trial by John P. Cione, BEDCO's chief compliance officer, as one of a "new breed" of young money-managers who emerged as highly successful in the stock market during 1969 and 1970. Yamada was committed to "special situations" and was one of a number of young advisers who were making mutual funds, hedge funds, and assorted speculative ventures very profitable (Tr. 1111). During the period of the complaint Yamada was handling six sizeable portfolios, three institutional and three individual, of which Dr. Rolf's was the largest individual account. Yamada traded plaintiff's stocks on a discretionary basis from April 1969 through January 1971 (Tr. 1041-42).

In 1972, defendant Yamada was enjoined by the Securities and Exchange Commission from engaging in fraudulent and manipulative practices in connection with the

purchase and sale of securities. On December 21, 1972, at the age of thirty, Yamada pleaded guilty before Judge Irving Ben Cooper of this Court to a criminal conspiracy to violate the federal securities laws as set forth in Count One of Indictment 72 Cr. 363, in connection with the sale of Lady Goldie Bracelet Co. securities. On May 18, 1973, Yamada pleaded guilty to two further violations of 18 U.S.C. §371 set forth in criminal informations 73 Cr. 426 and 73 Cr. 427, in connection with a securities fraud involving Microthermal Applications, Inc., and a manipulation of Health Evaluation Systems, Inc., the stock of the latter being one involved in this action. On June 26, 1973, Judge Cooper sentenced Yamada to two years in prison, five years on probation, and fined him $30,000. Thereafter, on April 15, 1974, Yamada pleaded guilty to submitting false statements to Judge Cooper in support of a motion to reduce or suspend his sentence, in violation of 18 U.S.C. §1001. For this crime, Judge Morris Lasker of this Court sentenced Yamada to one year, later reduced to six months, consecutive to the previously imposed period of imprisonment. (See DX-VV). Yamada admitted each of these convictions at trial, and further admitted that he had perjured himself before the Securities and Exchange Commission (Tr. 695).

The foregoing discussion raises questions regarding Yamada's credibility as a witness in this action. However, the Court finds that on many points Yamada's testimony is supported by that of Rolf or by documentary evidence. Further, the Court finds that it cannot credit the whole of the testimony of either of the other two principal witnesses, Dr. Rolf and Michael Stott.

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Plaintiff's Investment Intent

Dr. Rolf's claim that he was an unsophisticated investor is undercut both by the events leading up to and those during the period of the complaint. First, as noted, plaintiff in earlier years had engaged a series of brokerage firms on a non-discretionary basis. Further, plaintiff makes no complaint concerning the securities bought for his account by S. Logan Stirling of BEDCO from 1963 through March 1969, and there is substantial evidence that certain of those stocks were aggressive investments.

The best evidence of Rolf's investment intent during the Stirling period is contained in a letter from the plaintiff to Stirling dated June 14, 1967:

> "My objective is to double my equity. It will be interesting to see how long it takes." (DX-C)

Plaintiff testified that during the Stirling period, he would have been happy with an annual growth rate of ten percent, but that he would have been dissatisfied with anything less (Tr. 315).

There is substantial evidence that Dr. Rolf kept careful watch over his securities. During the period of the complaint, plaintiff checked the published prices of his securities three or four times per week (DX-III). He also employed a bookkeeper to keep track of his holdings and their value, both during the Stirling period and during the period of the complaint (Tr. 307; PX-24).

Further, although Rolf gave Stirling complete discretionary authority over his account (DX-P), the doctor telephoned Stirling's office as many as six times per week (Tr. 741). Rolf testified that he was fully satisfied with Stirling's

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handling of his BEDCO account, and pleased by the fact that the size of the portfolio more than doubled in the six years between 1963 and 1969.

In mid-March 1969, S. Logan Stirling took ill and left BEDCO, having suffered a brain tumor which proved fatal. Plaintiff claims, but the evidence does not support the conclusion, that Stirling was incapacitated as early as late 1968. However, the Court does conclude that from March through early May 1969, Rolf's million-dollar account went unattended by anyone at BEDCO. BEDCO's compliance officer admitted not only that the account was "dormant" during the period between Stirling's illness and Rolf's selection of Yamada, but further that during April 1969 some unidentified person at BEDCO sold one thousand shares of Talcott National Corp., purchased one thousand shares of Asamera Oil Corp., and sold one thousand shares of Occidental Petroleum Corp. (Tr. 1069-71; see DX-UU). This apparent indifference to plaintiff's investment needs at BEDCO is further illustrated by the manner in which Akiyoshi Yamada came to be selected as Rolf's investment adviser.

Michael Stott testified that following Stirling's departure from BEDCO, Mr. Schlesinger, a BEDCO partner, assigned the Rolf account to him. In late April 1969, Stott telephoned Rolf and offered to handle his account. Rolf stated that he wanted an investment adviser, and that Stott, while a capable and experienced broker, was just not an analyst with sufficient expertise to direct his investments. However, Rolf was willing to keep the account at BEDCO, and he asked Stott to recommend an investment adviser.

Stott testified flatly that he never knew what Rolf's investment objectives were (Tr. 881-82), and further, that he did not even look at the stocks in plaintiff's portfolio prior to their first contact (Tr. 941-48). Accordingly, the Court concludes that Stott recommended two advisers, Akiyoshi Yamada and Donald Geddes, knowing nothing about the plaintiff beyond the fact that Rolf's account had been handled by Mr. Stirling.

While Stott's trial testimony on the point is somewhat inconsistent with his deposition (see Tr. 888-89), it appears that Stott did little more than give plaintiff two names and two telephone numbers.

Dr. Rolf testified that Stott told him Geddes had experience with large accounts; however, according to the plaintiff, Yamada was more fully described. Stott told Rolf that Yamada had a Harvard Business School background, that he was from an illustrious and wealthy Japanese family and that he was a brilliant analyst. Rolf travelled to New York shortly thereafter to interview the two.

Rolf and Yamada met in a New York restaurant to discuss plaintiff's investments. Rolf thought Yamada both brilliant and capable, but was somewhat wary of Yamada's youth (Tr. 31). When Rolf spoke of an interest in preserving his equity, Yamada assured him that none of his clients had ever lost a penny (Tr. 30).

Yamada's testimony concerning Rolf's objectives is consistent with the rest of the evidence in the case. While Yamada stated that Rolf was unsophisticated and "groping" for guidance, it was clear to Yamada that Rolf wanted

a very aggressive investment program, and that he was willing to engage in extensive trading in order to "double his equity" (Tr. 511, 514; PX-3).

Yamada's testimony to the effect that Rolf was interested in special situations, new issues, and aggressive trading is confirmed by a letter written by Rolf to Yamada much later. In that letter dated September 2, 1970, Rolf referred to his original investment intent as follows:

> "As you recall, we started out with roughly $2,000,000. of Securities which could be used for trading. . . . It was my impression that we would wind up with 3.5 to 5 million in a years time." (PX-3)

In brief, Dr. Rolf decided that Yamada would be an appropriate investment adviser, and although he also interviewed Geddes, plaintiff settled on Yamada.

Rolf and Yamada agreed that Yamada would receive compensation equal to ten percent of plaintiff's capital gains. Rolf requested that trading be done through BEDCO and Stott, if at all possible. Rolf testified repeatedly, and the Court credits the statements, that Rolf sought to balance Yamada's youth and zeal with BEDCO and Stott's reliability and supervision. Indeed, in the plaintiff's mind, by the combination of Stott and Yamada, he was obtaining a "Stirling-type" operation (Tr. 35). Rolf told Stott that he expected BEDCO to look after his account, and that he didn't intend to keep his commission business at BEDCO without receiving something in return (Tr. 34). On May 9, 1969, Rolf executed a trading authorization granting to Yamada full discretionary authority over his BEDCO account:

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"Messrs. Eastman Dillon,
Union Securities & Co.

"Gentlemen:

"I hereby authorize AKI YAMADA to buy, sell, including short sales, and trade in, for my account and risk and in my name, stocks, bonds and any other securities . . . . You will kindly follow his instructions in every respect concerning my account with you . . . as he may order and direct. In all matters and in all things aforementioned he is authorized to act for me and in my behalf in the same manner and with the same force and effect as I might or could do . . . ." (DX-B)

The Stocks

It is clear from the evidence that in May 1969, Rolf expected Yamada to take substantial risks for capital gains, but at the same time to preserve the million dollar portfolio which Rolf had built up over the years through his own earnings and efforts and through the efforts of prior brokers. Indeed, since Rolf had no pension or retirement plan, his stocks represented his main security for his later years (Tr. 19).

It is also clear that Rolf expected BEDCO to supervise his account and Rolf understood that Stott was to look after his interests. As Rolf testified, he made this clear to Stott at the outset:

"I said, 'Mike, I can take this account any place. I am going to leave this account here,' but I said, 'Look, I want you to watch this. After all, you are going to be compensated for this, you are going to get all the commission business, and when I am back in Cleveland and busy, you keep your eye on things.' " (Tr. 34)

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Contrary to his expectations, Rolf received from Yamada only the substantial risks and he received no supervision by BEDCO. The explanation lies in how Stott and Yamada saw their respective roles and in the very effective methods they used to shuffle Rolf between the two of them.

On May 9, 1969, the date when Rolf gave Yamada the trading authorization, Rolf's margin account contained twenty-three issues, all but one of which had been purchased by Stirling:

Loew's Theatres Wts.
Leasco Data Processing Wts.
Anaconda Co.
Asamera Oil Corp.
Avnet Inc.
Buttes Gas & Oil Co.
CNA Financial Corp.
Cities Service Co.
Ebasco Industries Inc.
Glen Alden Corp.
INA Corp.
International Industries Inc.
General Electric Co.
Leesona Corp.
Levin Townsend Computer Corp.
Loew's Theatres Inc.
National General Corp.
Occidental Petroleum Corp.
Penn Central Co.
Pittson Co.
Raytheon Corp.
Scientific Resources Corp.
Teledyne Inc.
(DX-UU at 2)

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With the exception of the two warrants, each of the above securities were listed on the American or the New York Stock Exchange. Eighteen were issued by companies that had enjoyed continuous profits for five years or longer. Sixteen paid cash dividends. Yamada characterized six of the issues as "blue chip" and plaintiff's expert witness made similar observations. Yamada described the warrants as "aggressive" investments and two of the stocks as "racy". As of May 9, 1969, after reducing the value of the portfolio by the debit balance, plaintiff's margin account was worth $1,423,000 net.

Both Yamada and Rolf testified that they agreed in April 1969 to make certain changes in the account. Yamada was of the opinion that many of the stocks involved had seen their day, and that it was time to move on to newer and more profitable investments. However, Yamada stated that Rolf did not agree to liquidate the account; that decision was made by the adviser alone. Between May 1969 and January 1970, Yamada sold all 23 issues, 14 at a loss. Plaintiff made no complaint.

The evidence in this case most fraught with hazards concerning credibility is the testimony of Stott and Yamada regarding their relations with each other. However, it is clear that the two were in contact by telephone several times daily.[1] Further, Stott continually conveyed to Yamada the recommendations of BEDCO's research department with respect to certain issues, and many of those stocks were subsequently purchased for Rolf's account.

1. Stott testified in his deposition that he spoke to Yamada only twenty or thirty times during the entire one and one-half year period. However, at trial Stott admitted that he was in daily contact with Yamada (Tr. 775, 817).

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While Yamada and Stott met socially only on occasion, it is clear that their business interests were intertwined. Yamada stated that he relied upon Stott for recommendations with respect to oil and gas stocks; Stott's testimony on this point is equivocal.[2] There is no dispute that Stott had family connections with the management of two oil companies whose issues were purchased for Rolf, Standard Oil of New Jersey and West Coast Production.

Stott testified that he handled a total of six accounts referred to him by Yamada, but he stated that these accounts produced only a small proportion of his commission income (Tr. 794-95). Of the forty-one issues purchased for Rolf by Yamada and Stott during the complaint period, thirty-five were at some point traded through BEDCO (PX-24). Yamada testified that Stott recommended a total of twelve of the issues involved (Tr. 518-530); Stott admitted to recommending six of these.

With respect to the stocks which he did admit he recommended to Yamada, Stott testified that he did not specifically recommend the stocks for Rolf. Rather, Stott maintained that he simply gave Yamada the results of BEDCO's research, and that the recommendations were in actuality for Yamada's more speculative ventures, such as Takara Partners and the hedge funds (Tr. 780-81). The Court does not find this attempted distinction credible, particularly in light of the fact that Stott himself continually executed purchases and sales in these very stocks for Rolf's account; in these circumstances, there can be little

2. When asked if oil stocks were one of his specialties, Stott answered "not really" (Tr. 965). Stott did admit that Yamada bought Rolf oil stocks "partially" on his advice (Tr. 965).

doubt that Stott realized that Yamada was, at least in part, relying on the recommendations made by Stott and by BEDCO research in determining what to buy for the plaintiff; indeed, Stott admitted as much (Tr. 965).

Moreover, BEDCO's cross-index of all securities traded by Stott reveals that as to seven, not six, of the issues, Stott was at the time in question recommending and buying the stocks for his *non*-discretionary accounts of other customers (see PX-25). With regard to three more of the stocks listed by Yamada, the cross-index shows that Stott bought the issues for other investment advisers as well as for Yamada. Finally, as to one issue which Yamada claimed Stott was recommending, defendants report that there is no record in the cross-index as to whether or not Stott bought this issue for others (see PX-25). While PX-25, standing alone, does not establish that Stott recommended each of the twelve issues for Rolf, the document does serve to credit the testimony of Yamada to the effect that Stott was involved with the decision to purchase the issues.[3] Accordingly, in light of all of the findings hereinabove, and weighing all the evidence on the question, including the Court's observation of the demeanor of the witnesses, the Court concludes that Stott either recommended or was somehow involved with the decision to purchase the following twelve securities for plaintiff:

Simplex Wire & Cable Co.
Teradyne, Inc.
Standard Oil, N. J.
Reading & Bates Offshore

3. The Court notes that Yamada's testimony as to the twelve issues allegedly recommended by Stott was given *before* defendants produced the documents constituting the cross-index, PX 25.

Intertherm, Inc.
Food Fair Properties
International Funeral
Natomas Corp.
Asamera Oil Corp.
Carter Wallace, Inc.
West Coast Production
Equity Funding Corp.
(PX-25; Tr. 518-530)

Accordingly, contrary to his testimony at trial, the Court finds that Stott was indeed involved with the management of the Rolf account, particularly during the first eight months of the complaint period.

One internal regulation at BEDCO prevented the trading of certain stocks through the firm. According to BEDCO's compliance officer, BEDCO would not solicit stocks which were selling at less than $5.00 per share (Tr. 978-79). For this reason, as well as for reasons of his own, between May 1969 and March 1971, Yamada opened no less than eight other accounts in plaintiff's name at eight different brokerage firms. Plaintiff stated that he was almost completely ignorant as to why all these other accounts were being opened. Upon inquiry, he learned that in some cases, Yamada had opened the accounts to give other broker associates some business; in other cases, Yamada opened the accounts to buy stocks from the firms that were engaged in underwriting new issues which BEDCO would not handle.

Despite these new accounts and the purchase and sale of stocks through those houses, Dr. Rolf was under the impression that BEDCO was looking after his portfolio

as a whole. Indeed, the BEDCO account was a custody account, and in the great majority of cases where stocks were bought elsewhere by Yamada, Stott nevertheless received confirmation slips and the securities were delivered into BEDCO. Even though BEDCO received no commissions on these outside purchases, in a few cases the stocks were subsequently sold through BEDCO, producing commissions for Stott and his employer. According to Dr. Rolf, Stott assured him that BEDCO could still oversee the account since the stocks were often delivered in, and since confirmation slips were sent to Stott.

As Yamada's liquidation program quickly resulted in a wealth of new issues, many of which were over-the-counter stocks, Dr. Rolf was apparently both excited by the challenge of speculation and concerned over the strange names of the new issues. Beginning in July 1969, Rolf began calling Stott for assurance and for information about the new stocks. Stott testified that Rolf called him six or seven times per month from July 1969 through May 1970. Thereafter, Stott or his secretary called Rolf every day to give him quotations on the over-the-counter prices. There is no evidence that Rolf and Yamada were in such frequent contact.

The testimony is consistent that Rolf called Stott to complain about the amount of trading and the nature of the stocks in the account. Stott stated that he simply told Rolf to speak to Yamada. However, plaintiff's version of the calls, which is supported by certain documentary evidence and by the testimony of Yamada, is that Stott continually assured Rolf with respect to Yamada's competence and ability, and that Stott repeatedly stated that if Yamada

had decided to buy a stock, then Stott was sure that it was okay. Yamada referred to this arrangement as a procedure whereby if Rolf called him to complain, Yamada would call up Stott and tell Stott to speak to Rolf and "hold his hand." (Tr. 545). The Court finds that this was exactly what occurred.

Rolf believed that Stott was intimately involved with the management of the account. Indeed, since Stott and Yamada were in daily contact discussing securities which ended up in the plaintiff's account, Rolf's was a reasonable belief. It was moreover a correct belief; Stott *was* involved with the management of the account.

The period between May 1969 and January 1970 was characterized by the sale of the listed stocks and the purchase of very different issues. While there was some short-swing trading in U. S. Natural Resources between May 22 and 26, 1969 (DX-UU at 3), and while there was one short-swing trade of International Funeral Services in December 1969 (DX-UU at 17), Yamada's program during that period was a gradual liquidation of the Stirling securities and the purchase of large quantities of unlisted and even restricted stocks. By the completion of the transformation in January 1970, the account stood as follows:

Delanair, Inc. (restricted)
Food Fair Properties, Inc.
Holobeam, Inc.
Monarch Industries, Inc.
Synchronex Corp.
West Coast Production Co.
Benquet Consolidated Corp.
Equity Funding Corp.

Outlet Company
Simplex Wire & Cable Co.
(DX-UU at 20)

In eight months, the value of Rolf's securities had dropped by over $700,000. Further, while his net position was approximately $712,000, $338,000 of this was invested in Delanair, a restricted stock through which plaintiff was clearly defrauded by Yamada.

In August of 1969, Yamada persuaded Rolf to invest nearly $400,000 in stock, calls and warrants of Delanair, Inc. The securities were purchased through BEDCO, but the parties all agree that the stock was initially Yamada's idea and that Stott received no commissions on the purchase. Rolf was concerned that the investment would tie up too large a portion of his money, so he telephoned Stott after he had spoken with Yamada but before the funds had been committed. Stott stated that if Yamada had recommended the transaction, then it must be okay; in effect, Stott said to go through with it (Tr. 82). The Court does not accept Stott's statement to the effect that he never discussed the stock with anyone.

The lure of the Delanair investment was Yamada's representation to plaintiff that there would be a secondary or a public offering of the stock in six months and that Rolf would double or triple his investment thereby. Rolf stated at trial, and the Court finds, that Yamada's promise of a secondary offering was fraudulent.

Delanair never did achieve a secondary offering, and plaintiff found himself with restricted stock which rapidly declined in value. In 1972 Rolf brought a civil action

against Delanair, Yamada, D. H. Blair & Co., and others; in 1973 that action was settled for $175,000.[4] BEDCO was not a party defendant to that action (DX-NN through DX-QQ). When asked to assess the quality of the Delanair issue, plaintiff's expert witness described the stock as the "lowest of the low".

Four of the issues in plaintiff's BEDCO account as of January 1970 were, as the Court has found, bought on Stott's recommendation or with his participation: Food Fair, West Coast Production, Equity Funding, and Simplex Wire. Each of these stocks was eventually sold at a loss, the total amounting to over $65,000. However, there is no evidence that any of these four stocks were unsuitable for Rolf.

Monarch Industries was another substantial investment made by Yamada for Rolf in an obscure issue which resulted in a substantial loss. The stock was both bought and sold through brokerage houses other than BEDCO. Although Yamada stated that he discussed the stock with Stott between May and June 1969, he testified that the investment was his own decision. Rolf lost $159,000 on the transaction (PX-24). Plaintiff's expert witness rated Monarch as "low quality".

Two other stocks bought in this period merit discussion, for they indicate the beginning of Yamada's trading for Rolf in securities which Yamada knew were being manipulated. The evidence is equivocal with respect to whether Holobeam, bought in January 1970, was manipulated, but Yamada testified that Synchronex Corp., purchased in Octo-

4. Thus, here plaintiff seeks damages of $225,000 only by reason of the Delanair matter.

ber 1969, was a manipulated security. It is clear that neither Stott nor Rolf knew that these stocks were being used as vehicles to defraud others. Plaintiff's expert described the quality of these two stocks as "lowest of the low".

While there were many fewer trades in February and March 1970 than there had been in prior months, the market values of Delanair, Holobeam, Monarch and Synchronex declined drastically. On March 29, 1970, the net value of Rolf's account had fallen to $446,000, nearly half of which was still in Delanair. (See DX-UU at 22-24). Rolf by this time was becoming highly disturbed about his stocks, and as noted above, he began calling Stott on a regular basis. In early April 1970, Rolf called Stott and complained that there had been in excess of five million dollars in transactions in the account since May 1969. For the first time Stott responded in writing, and for the first time Stott began to maintain that he was only an "order taker". In a letter dated April 10, 1970, Stott wrote to Rolf as follows:

> "As you know, I have absolutely nothing to say over the management and handling of this account. When you signed your contract with Aki it gave him complete discretion. All I am with this account is basically an order taker.
>
> "I think what you should do is sit down with Aki and spell out a complete program to help you recoup the losses that have been incurred in this account in the past year or so." (DX-E).

Yamada stated that in his opinion this letter was false since Stott was much more than an order taker (Tr. 548).

This was also Rolf's view as is seen from a letter written to Stott by Rolf in reply, dated April 15, 1970:

> "Since you work closely with Aki, these are his plans for the near future:
>
> 1. The utilization of warrants and options as they come up.
>
> 2. A take out on Monarch Industries.
>
> 3. Placement of Delanair when the Secondary comes out.
>
> * * *
>
> "In the meantime, I would appreciate your doing the following:
>
> 1. Have your secretary get a daily quote on my O-T-C securities.
>
> 2. Notify me promptly if there is a significant change up or down.
>
> 3. Keep me informed regarding any information you consider pertinent."
> (PX-1)

Stott testified that while he did not make a written reply to this letter, he did call Rolf and stress that Yamada, and not the broker, was the one handling the account. However, it is clear from the correspondence that followed in the fall of 1970 that Rolf failed to get the message. In September, he sent Stott another letter detailing Yamada's plan for recouping losses (PX-2, PX-3). On October 7, 1970, Rolf wrote a letter to Stott which ended with the admonition: "Remember—you're my man in N.Y. *Please keep* the *program on target.*" (PX-4).

Finally, on December 14, 1970, Rolf wrote to Stott asking him to "please keep your pulse on the situation and also keep me informed." (PX-5). Stott never wrote back to correct that which he now maintains was a continuing misimpression on Rolf's part as to BEDCO's duties.

Despite the fact that Yamada had opened eight new accounts for him, Rolf apparently was not content to leave the management of all of his securities to his adviser. In June 1969, Rolf had opened a non-discretionary account at Hornblower & Weeks Hemphill, Noyes, and over the following months he bought five issues there. The stocks were as follows:

American Scientific Corp.
Dasa Corp.
Data Network Mega Systems, Inc.
Ampex Corp.
Mohawk Data Science
(DX R, DX R-1)

Rolf testified generally that he did not really know anything about these stocks. Indeed, plaintiff's own expert witness, on cross-examination, testified that Dasa Corp. was a "low quality" issue.

During this period, Yamada turned to even more speculative issues in order to make some profits for the plaintiff. He also began investing in issues which he testified were manipulated. According to Yamada, during the Delanair and Monarch ventures, Stott became concerned that there was a lack of trading in the account, and thus a lack of commissions. It is clear that Yamada had no interest in

commissions for himself; his compensation was to come from a percentage of capital gains and further, Yamada was given the opportunity to employ Rolf's account as "buying power" for his own manipulations.

According to Yamada, in April 1970 Stott informed him that his superiors at BEDCO were becoming concerned about the Rolf account. However, this statement is not supported by any other evidence and thus the Court is not inclined to credit the testimony. Nevertheless, the Court does give some weight to Yamada's statement that Stott referred to the stocks in the Rolf account as "junk." (Tr. 542-44).[5]

In brief, the Court concludes on this point that Stott did indeed consider many of the securities to be "junk" and that he told this to Yamada. However, it is clear that he never made such a statement to Rolf, and all parties agree that Stott never recommended against any purchase.

During 1970, Yamada bought for Rolf the following securities which Yamada knew were being manipulated, either before or shortly after the dates of purchase:

Visual Sciences, Inc.
Health Evaluation Systems
Hair Extension Centers
GPI Enterprises, Inc.
MH Studios
Tranquilaire Mental Health
Creative Polymer Products

5. Again, Stott's testimony on the point is equivocal; Stott denied that he had ever threatened to tell Rolf about the "junk" in the account unless Yamada gave him more commissions; however, Stott stated that he did not know if he ever used the term "junk" to describe low quality securities (Tr. 842).

Plaintiff's expert testified that in his opinion each of these stocks were "lowest of the low" quality. Many were new issues; all were highly speculative; public information was unavailable as to the majority of the issuers. Stott denied that he recommended any of these stocks, and Yamada testified that he traded in these stocks on his own. Five of the stocks were traded at other brokerage houses, and there is no credible evidence that Stott was aware of the fact that Yamada was using these stocks as vehicles to defraud. Further, Rolf was not the victim of the manipulations; Yamada made fairly substantial profits for Rolf on short-term trading in six of the seven manipulated stocks. Indeed, Yamada testified that in his opinion these stocks were suitable for Rolf (Tr. 696-702). For the reasons discussed within, the Court concludes otherwise.

Yamada also undertook further schemes in an attempt to recoup losses for Rolf through speculative ventures. Yamada and Rolf decided to sell Monarch Industries at a significant loss and invest the proceeds in the Takara Partners hedge fund. Yamada also continued to assure the plaintiff that Delanair would some day come through with its secondary offering. As late as September 1970, Rolf still apparently believed that he could regain his lost capital by speculative ventures, including "special situations", "new issues" and "founder's stock" (see PX-3). He wrote to Yamada by letter dated September 2, 1970, and indicated that he was continuing to discuss with Stott the question of Yamada's competence to achieve plaintiff's investment goals. In this letter Rolf began to once more emphasize the need for preservation of capital:

> "For future endeavors in the years to come, it is obvious that we must again regain the same substantial base we started from. The old rule that the preservation of capital is the first rule of investment has never been more true."
> (PX-3)

Through the end of the year 1970, as plaintiff's net position declined to $225,000, Rolf continually sent to Stott copies of his correspondence with Yamada. It was during this period that Rolf referred to Stott as his "man in New York" and asked Stott to keep his pulse on the situation. However, in late January 1971, Rolf took the step of purchasing four conservative listed bank stocks through another broker at BEDCO. Shortly thereafter, the SEC investigation of Yamada became public knowledge. BEDCO was visited by representatives of the Commission. BEDCO's chief compliance officer called Stott in and informed him that BEDCO would take no further orders from Yamada for the Rolf account. Shortly thereafter plaintiff was informed of the SEC investigation. The balloon of Yamada's manipulations was collapsing.

In his testimony at trial, Yamada described the functional aspects of the several manipulations involved in this lawsuit. Generally, Yamada along with a group of other money managers and underwriters would seek to obtain control of new, thinly-traded, over-the-counter securities. Once the group had purchased the great majority of the outstanding shares, they would begin to trade the stock up, by selling to each other at gradually higher and higher prices. Thus, the market price would be manipulated upwards, and other investors would become interested in the

stock, thinking that the price rise was due to legitimate factors. At the end of the manipulation, the conspirators would sell out, leaving an unsuspecting group of investors with a large amount of artificially-inflated stock. Often, once the manipulaters left the scene, the price of the stock would plummet, as was the case with Health Evaluation Systems (Tr. 624-25).

Yamada testified that he often assured Stott that these stocks were "under control" and that the price would "go up". Similarly, Yamada stated that he told Stott there was a "box", a term Yamada used to encompass not only control over a given security, but also an illegal manipulation (Tr. 600-27). Stott testified that he knew nothing wrong about any of these stocks, in effect denying that he ever knew of the manipulations. Stott also denied ever hearing the term "box" used to imply or indicate a manipulation (Tr. 842-57). Faced with this direct conflict between Yamada and Stott's testimony, the Court chooses to discredit the allegations made by the investment adviser. However, as noted above, the Court does find that Stott knew these stocks were highly speculative, that they were "high-fliers" and that for the most part, they were "junk".

At trial, Stott described what he believed were his duties to Rolf during the period in question. In brief, Stott claimed that he was no more than an "order taker" whose job it was to add up the debits and the credits. Stott saw himself as a "bookkeeper" (Tr. 814) and he limited his supervisory activities to a five-minute monthly review of the plaintiff's statements (Tr. 821). Stott testified that he believed the phrase "my man in New York" in Rolf's October 1970 letter (PX-4) to mean that Rolf expected Stott to

act as a diligent order taker (Tr. 833). He stated that to him, the phrase "please keep your pulse on the situation" in PX-5 meant that Rolf expected him to add up the debits and the credits accurately (Tr. 836). Stott stated that he *never* knew plaintiff's investment intent (Tr. 881-82). Stott also stated that he never sent Health Evaluation or Hair Extension through BEDCO research to determine whether either was an appropriate investment for plaintiff (Tr. 901).

Stott and his employer maintain that they are relieved of almost every regulatory and fiduciary duty owed to Rolf solely because of the trading authorization executed by Rolf for Yamada. When asked by the Court to describe his view of his duties to a customer where the account was being traded by an investment advisor, Stott responded as follows:

> "Unless there was something blatantly wrong with the order that I got from an investment advisor, or I had knowledge that this was, you know, something illegal was going on in the security, and if my firm permitted the order to be executed, I felt it was perfectly all right, yes. That is what I had been told." (Tr. at 863)

The testimony of BEDCO's chief compliance officer, John P. Cione, was to the same effect. As far as BEDCO was concerned in 1969-1970, if an investment advisor was in the picture, the brokerage firm was relieved from (1) the duty to investigate trading that appeared to be excessive; (2) the suitability of transactions made for the customer through the firm; and (3) the general duty to know the customer and learn the essential facts about him and his needs (see Tr. 1095).

Although BEDCO employed a computer-assisted program to detect excessive trading, and although that system was able to detect any monthly trading in any account which would exceed 3.5 if computed for an annual period, Cione testified that once the compliance officer determined that the trading was occurring in an investment advisory account, no further questions would be asked (Tr. 1074). Further, said Cione, even had the officer gone further and spoken to Stott, the fact that Yamada was the adviser would have itself foreclosed further inquiry, due to Yamada's reputation at the time.

BEDCO did no study of any of the stocks bought for Rolf elsewhere and delivered into the custody account. While the firm did require that any stock with a rating below B-plus receive special research approval before a broker could recommend it, BEDCO did not apply any such "suitability" standard to stocks purchased in discretionary accounts run by investment advisers (Tr. 1049). Thus, despite the fact that many of the stocks bought for Rolf were not even listed in any rating manuals at all, and despite the fact that many of them were "high-flying" new issues which Yamada was manipulating, BEDCO never identified as unsuitable any security purchased for Rolf.

Thus, with the exception of the recommendations made by Stott in the early part of the period, it appears that the only services rendered to Dr. Rolf by Stott and BEDCO were trading the account and dutifully mailing to plaintiff confirmation slips. For these efforts the defendants BEDCO and Stott received commissions in a total amount

of approximately $42,000. Stott testified that his one-third share was only a small percentage of his total income in 1969-1970.

Discussion

The Duties of Brokers

The registered representative of a broker dealer occupies a unique position in the scheme of securities regulation. Since he as broker is the person who actually trades securities for the investing public, his very employment is "in connection with the purchase and sale of securities." (Rule 10b-5). Indeed, a broker such as the defendant Stott conducts himself and carries out his daily routine through the instrumentalities of the national security exchanges and the over-the-counter market. (Rule 10b-5; Rule 15cl-2).

For these and related reasons, courts have concluded that the broker, by virtue of his position, owes a fiduciary duty to his customer. *Moscarelli* v. *Stamm,* 288 F.Supp. 453 (E.D.N.Y.1968); *Lorenz* v. *Watson,* 258 F.Supp. 724 (E.D.Pa.1966). See *Carras* v. *Burns,* 516 F.2d 251, 258 (4th Cir. 1975); *Hanly* v. *SEC,* 415 F.2d 589, 597 (2d Cir. 1969). Since brokers are traditionally compensated by commissions in direct proportion to purchases and sales, the opportunity to take advantage of the client is always present. To ensure that the broker fulfills his fiduciary duty, and to protect against frauds upon the customer, the broker and his employer are made subject to a series of obligations, the fraudulent breach of which may render

them liable to the investor in damages. See *Zweig* v. *Hearst Corp.*, 521 F.2d 1129, 1135 (9th Cir.), *cert. denied*, 423 U.S. 1025, 96 S.Ct. 469, 46 L.Ed.2d 399 (1975); Jacobs, *The Impact of Securities Exchange Rule 10b-5 on Broker Dealers*, 57 Cornell L.Rev. 869 (1972). Among the possible liabilites involved in the instant action are damages for alleged violations of Rule 10b-5 and Rule 15cl-2, and of the rules of the New York Stock Exchange and of the National Association of Securities Dealers.

Rule 405 of the New York Stock Exchange provides in part as follows:

> "Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) to
>
> "(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization. [and to]
>
> "(2) Supervise diligently all accounts handled by registered representatives of the organization."

Article III, Section 2 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc., provides as follows:

> "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

These rules and others impose a series of duties upon brokers which may be enforced through SEC enforcement actions and, increasingly, through private actions. While the rules of the NYSE and the NASD set forth duties which, by the language of the rules, appear to sound in negligence, when their breach operates in a manner tantamount to fraud, liability under Rule 10b-5 may be present. See *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 143 (7th Cir.), *cert. denied*, 396 U.S. 838, 90 S.Ct. 98, 24 L.Ed.2d 88 (1969).

The broker/customer relationship is rife with implied representations as to the broker's honesty, diligence and competence. It has been suggested that the failure to comply with the implied representations of due diligence and suitability can constitute a device or scheme actionable under Rule 10b-5. See *Starkman* v. *Seroussi*, 377 F.Supp. 518, 524 (S.D.N.Y. 1974) (Weinfeld, J.). As Judge Timbers wrote, albeit in an enforcement proceeding:

> "Brokers and salesmen are 'under a duty to investigate, and their violation of that duty brings them within the term "willful" in the Exchange Act.' Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. . . . The fact that his customers may be sophisticated and knowledgeable does not warrant a less stringent standard." (*Hanly* v. *SEC*, 415 F.2d 589, 595-96 (2d Cir. 1969) (footnote omitted)).

In this case Dr. Rolf claims that the defendants Stott and BEDCO breached fiduciary duties owed to him by virtue of their position. Rolf also asserts Rule 10b-5 liability for churning, and secondary liability for aiding and abetting. Defendants' primary defense is the trading authorization.

Through their witnesses and in their submissions, defendants have argued that the trading authorization executed by Rolf operated to immunize BEDCO and Stott from all liability, and that it relieved them of the various regulatory and fiduciary duties described above. However, despite all these protestations and opinions rendered by the defendants with respect to the matter, the Court must note that defendants have cited absolutely no federal authority to support their argument that the presence of a trading authorization operates to relieve a member firm of its NYSE and NASD duties to its customers.

Rather, as Professor Jacobs has written, "contractual privity is not a *sine qua non* of broker liability." Jacobs, *supra* at 876.

License revocation proceedings before the Securities and Exchange Commission provide the most persuasive authority on the question. In *In re William I. Hay,* 19 S.E.C. 397 (1945), an investment adviser holding a power of attorney engaged in cross-trading and self-dealing, defrauding a number of clients whose stocks were traded through respondent's brokerage house. Further, the adviser bought for his clients large quantities of hopelessly speculative securities. In that proceeding, the brokers asserted the identical defense heard here—that they were

fully authorized to accept directions from the adviser, that they never directly advised the clients, and that the power of attorney insulated them from all direct brokerage duties to the clients. The Commission found the argument to be without merit.

Starting from the proposition that the respondent must have known of the adviser's frauds because they were self-evident, the Commission placed upon the brokers a duty of full disclosure to the customer. See 19 S.E.C. at 406-07. Further, the Commission concluded that the brokers had a duty to inform the clients concerning the speculative and financially unsound nature of the investments. The only alternative open to the respondents, the Commission concluded, was to refuse to accept further orders from the adviser.

> "Respondents adopted neither course. The result was that the customers were utterly without protection—served by two agents, one with discretionary power over their account acting faithlessly, and the other a broker, knowing of the faithlessness yet claiming to be free of any duties." (*Id.* at 407).

A similar principle was announced by the Commission a few years later. *In re Moore & Co.,* 32 S.E.C. 191 (1951), involved a situation where the adviser, one Furlong, manipulated the accounts of his clients through one Mrs. Ross, a broker with the respondent firm. Although she had engaged in cross-trading, simultaneous buying and selling, and other fraudulent transactions at Furlong's direction, the broker testified that she believed the adviser was authorized to engage in such activities. The Commission re-

jected the notion that Mrs. Ross was relieved of her usual duties as a broker:

> "Furlong's power of attorney to deal on behalf of his customers, rather than leading Mrs. Ross to believe, as she contends, that they authorized Furlong's conduct, should have made her realize that he was subject to a high standard of fiduciary responsibility and loyalty with which the transactions in question were on their face inconsistent. Under such circumstances, she could have insulated herself from responsibility only by making the fullest disclosures to his customers or by making certain that his conduct was actually authorized by his customers. She did neither." (32 S.E.C. at 196).

Drawing an inference of willfulness from the circumstances, the Commission determined that the broker's registration should be suspended.

Against the rather substantial thrust of these decisions, defendants present only a single case on point, *Carroll* v. *Doolittle*, 21 Misc.2d 203, 191 N.Y.S.2d 398 (1959). There the state trial court determined that a broker had no state law fiduciary duty to enquire behind the decisions of an investment adviser. This Court is constrained to reject *Carroll* and to accept the view of the Securities and Exchange Commission. While the precedent of SEC actions is not controlling in this civil suit for damages, the Court does find the Commission's decisions persuasive.

As the federal agency charged with the multifaceted duties of registration and regulation of broker dealers, as well as with the primary responsibility for enforcement of securities laws designed to protect the investor, the Commission must be afforded the appropriate degree of deference and its administrative judgments accorded great weight. See *SEC* v. *Chenery Corp.*, 332 U.S. 194, 209, 67 S.Ct. 1575, 91 L.Ed. 1995 (1947).

In this case there are additional reasons supporting the conclusion that the execution of the trading authorization did not operate to relieve Stott and BEDCO of their usual duties as brokers or to insulate them from liability under the securities laws. Here Dr. Rolf had for six years received from BEDCO the services of an investment adviser and a broker, through the offices of S. Logan Stirling. During that period BEDCO placed Rolf into aggressive but high quality investments. Rolf clearly expected, and the Court concludes he had a right to expect, that BEDCO would continue to exercise some informed judgment on his behalf during the Yamada period. Indeed, during this period Rolf had working for him at BEDCO one of the firm's largest producers, Stott, who had been a branch manager at two different BEDCO offices.

In addition, it was BEDCO, not Yamada, that was a member of the Stock Exchange and of NASD during the period in question. BEDCO, as a large firm in a highly regulated business, was required to implement a series of safeguards to protect its customers. Yamada was associated with no brokerage firm and, as far as the Court is aware, had no direct access to any research department. Despite his credentials and his reputation at the time, Yamada was not in any position and had no express obligation to perform for Dr. Rolf each of the assorted duties imposed upon broker dealers by the NYSE and NASD rules.

Further, even if in the abstract a trading authorization relieves the broker from his usual supervisory and due diligence duties, here the conduct of the defendant Stott resulted in his direct participation in the management of the account. While Yamada had the authorization, the Court has found that Stott influenced Yamada's decision-making and recommended to Yamada stocks for Rolf. By these actions, Stott himself pierced the veil of any protection the power of attorney might have given to him or to BEDCO. A broker cannot recommend stocks to an investment adviser at will and then back off and claim he was no more than an "order taker" when such judgments are challenged.

Finally, the Court notes that defendants are unable to point to any language in the NYSE rules which indicates that the duties of a broker are lessened when an investment adviser handles the account. Indeed, the language of Rule 405(1) which requires the broker to discover all pertinent facts with respect to the adviser indicates to this Court that due diligence is required in this situation also.

Accordingly, under the facts and circumstances herein, and upon the authority of the decisions discussed above, the Court concludes that the execution of the trading authorization in this case did not relieve BEDCO or Stott from their duties to supervise the account and to employ due diligence with respect thereto.

Churning

When a broker engages in excessive trading in disregard of the customer's investment objectives for the purpose of

generating commission business, the customer may hold the broker liable for "churning" the account in violation of Rule 10b-5. See *Carras* v. *Burns*, 516 F.2d 251, 258 (4th Cir. 1975); *Greenfeld* v. *D. H. Blair & Co.*, [1975-76] CCH Fed.Sec.L.Rep. ¶95,239 (S.D.N.Y. 1975). As part of his proof, plaintiff must also demonstrate *scienter*, that is, that the broker acted with intent to defraud or with a willful and reckless disregard for whether his actions constituted fraud. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976); *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc); see *Arthur Lipper Corp.* v. *SEC*, 547 F.2d 171 at 180 (2d Cir. 1976).

To prevail on this claim, plaintiff must show not only that the trading in his account was excessive under the cases, but further that the amount of the trading was unjustified in light of his investment objectives. *Van Alen* v. *Dominick & Dominick*, 71 Civ. 5438 (S.D.N.Y. December 22, 1976); *Newburger, Loeb & Co.* v. *Gross*, 365 F.Supp. 1364, 1371 (S.D.N.Y. 1973); *Hecht* v. *Harris, Upham & Co.*, 283 F.Supp. 417, 435 (N.D.Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970).

Here the plaintiff has failed to establish the first element of churning, that of excessive trading. During the period of the complaint, the annual turnover rate, even as calculated by the plaintiff, was never any higher than 1.85. This is not excessive under the decisions. See *Van Alen* v. *Dominick & Dominick, supra; Moscarelli* v. *Stamm*, 288 F.Supp. 453 (E.D.N.Y. 1968); *Hecht* v. *Harris, Upham & Co., supra*. Indeed, it is the view of at least one commentator that an annual turnover rate will not be considered

excessive unless it begins to approach six. See Note, Churning by Securities Dealers, 80 Harv.L.Rev. 869 (1967).

The Court's finding that the turnover was not excessive is confirmed by the other circumstances present in the case. First, much of the turnover during the year 1969 came as a result of Yamada's liquidation of the Stirling securities, a major overhaul of the account which plaintiff approved. Further, it is clear that plaintiff expected that the proceeds of the liquidation would be used for "trading" rather than for long-term investment. See PX-3. As the foregoing factual discussion indicates, plaintiff's primary goal was capital growth; he was willing to take the risks involved in short-term trading, and he never instructed Yamada not to engage in short-swing trades. Plaintiff's twice-stated investment intent was to double his equity; indeed, in 1969 he expected his equity to double in approximately one year. In brief, the Court concludes that Dr. Rolf was a trader, not an investor, and that he is now estopped from maintaining that there was excessive trading in his account. See *Landry* v. *Hemphill, Noyes & Co.*, 473 F.2d 365 (1st Cir. 1973).

While the presence of Yamada does not operate to relieve Stott and BEDCO of their duties as brokers, the fact that the adviser made the majority of the investment and trading decisions militates against any finding that Stott traded the account in order to generate commission business. At trial, Yamada set forth his own reasons for many of the transactions herein, and while Yamada's reasons were not entirely legitimate—involving as they did "free-riding" stock manipulations—it is clear that the trades were not without some investment purpose. Further, Stott

did not have exclusive control over the buy and sell decisions, even though he had some influence upon Yamada's decision-making process. A finding that the broker had virtually exclusive control over the trading is a necessary prerequisite to liability for churning. See *Carras* v. *Burns*, 516 F.2d 251, 258 (4th Cir. 1975); *Greenfeld* v. *D. H. Blair & Co., supra; Hecht* v. *Harris, Upham & Co., supra*, 283 F.Supp. at 433; see also *Newburger, Loeb & Co.* v. *Gross*, [Current Binder] CCH Fed.Sec.L.Rep. ¶95,649 (S.D.N.Y. July 8, 1976). Accordingly, the churning claim must be dismissed.

Rules Violations

Since the Court has concluded that the defendant Stott was not aware of the manipulations in the Rolf account and that Stott did not churn the account, plaintiff's only remaining claims are based upon alleged violations of the NYSE and NASD rules. Accordingly, the Court must enquire into the open question of whether or not an investor may prevail in a private cause of action based upon violations of the regulatory rules.

In *Colonial Realty* v. *Bache & Co.*, 358 F.2d 178 (2d Cir. 1966), the court concluded that no private cause of action could be brought under the Exchange Act to hold a broker liable in damages for failure to employ "just and equitable" principles of trade, as required by the NASD rules. The court reasoned that such liability would too closely parallel the common law, and that the concept of "just and equitable" principles of trade was so vague and broad that enforcement would be impossible. However, the Second Circuit in *Colonial Realty* did not foreclose the possibility

that NYSE or NASD rules might support a federal securities action in this court; indeed, the court indicated that in considering the question, one must look to the nature of the particular rule and its place in the regulatory scheme. Further, the court stated that the case for implication of a right of action would be strongest where the rule set forth a duty unknown at common law. 358 F.2d at 181-83.

Applying these or comparable principles, a series of decisions have accepted the proposition that in an appropriate case, violations of exchange rules designed for investor protection might give rise to a private cause of action. See *Ocrant* v. *Dean Witter & Co.*, 502 F.2d 854, 858 (10th Cir. 1974); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 141 (7th Cir.), *cert. denied*, 396 U.S. 838, 90 S.Ct. 98, 24 L.Ed.2d 88 (1969) (NYSE Rule 405 held actionable); *Avern Trust* v. *Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969), *cert. denied*, 397 U.S. 963, 90 S.Ct. 997, 25 L.Ed.2d 255 (1970) (NASD rules actionable).

While the parties have not cited, and the Court's research has not found, any reported decision which has held a broker liable solely for the violation of NYSE or NASD rules, a series of district court decisions have accepted the proposition that such liability may lie, and the cases have fashioned the contours of liability for rules violations.

In this district, Judge Weinfeld has expressly held that violations of NYSE rules 345 and 405 are actionable. See *Starkman* v. *Seroussi*, 377 F.Supp. 518 (S.D.N.Y. 1974). Another decision refused to find actionable one NASD rule that imposed the duty to keep proper books, reasoning that the NASD rule, like that considered in *Colonial Realty*, was too vague to be enforceable. *Gurvitz* v. *Bregman & Co.*,

379 F.Supp. 1283 (S.D.N.Y. 1974). Another decision in this district dismissed claims of rules violations where the allegations of the complaint did not set forth a claim of fraud. *Bell* v. *J. D. Winer & Co.*, 392 F.Supp. 646 (S.D.N.Y. 1975) (Tyler, J.). A recent decision by Judge Newman in the District of Connecticut has concluded that violations of the NYSE and NASD rules are *not* actionable. *Plunkett* v. *Dominick & Dominick, Inc.* [Current Binder] 414 F.Supp. 885 (D.Conn. 1976); see also *Zagari* v. *Dean Witter & Co.* [Current Binder] CCH Fed.Sec.L.Rep. ¶95,777 (N.D.Cal. Sept. 27, 1976).

The starting point of the analysis is an inquiry into the place which the specific rules occupy in the entire regulatory scheme. In this regard, the Court notes that the Securities and Exchange Commission has enacted regulations comparable to the suitability and the supervisory rules of the NYSE and the NASD; see 17 C.F.R. §§240.15b10-3 and 240.15b10-4 (1976); *Plunkett* v. *Dominick & Dominick, Inc.*, *supra*, 414 F.Supp. at 890 n. 5. With respect to the types of duties imposed by the language of the NYSE and NASD rules themselves, the Court agrees with Judge Weinfeld's reasoning in *Starkman* v. *Seroussi, supra,* and concludes that NYSE Rule 405 and Article III, Section 2 of the NASD rules are sufficiently precise to sustain a cause of action. Further, there can be no doubt that the purpose of these rules is to protect the investor. Finally, since particularly in this action the duties imposed upon the defendants may be unknown at common law, see *Carroll* v. *Doolittle, supra,* the Court concludes that this action presents a strong case for the implication of a civil right of action under the NYSE and NASD rules.

Since Rule 10-5 and 15cl-2 of the Exchange Act are directed essentially at fraud, any definition of what is actionable under NYSE Rule 405 and Art. III §2 of NASD should be narrowly drawn. See *Hecht* v. *Harris, Upham & Co., supra,* 283 F.Supp. 417, 430. Indeed, each court that has considered the question has concluded that mere negligent violations of the NYSE or NASD rules are not actionable in federal court; rather, to form the basis for liability in damages, the broker's violations of the rules must be "tantamount to fraud". See *Buttrey* v. *Merrill Lynch, supra,* 410 F.2d at 143; *Bell* v. *J. D. Winer, supra; Geyer* v. *Paine Webber Jackson & Curtis, Inc.,* 389 F.Supp. 679 (D. Wyo. 1975) (mere negligence insufficient); *Wells* v. *Blythe & Co.,* 351 F.Supp. 999, 1001 (N.D.Cal. 1973) (rules violations not "per se" actionable); *McCurnin* v. *Kohlmeyer & Co.,* 347 F.Supp. 573 (E.D.La. 1972) (plaintiff must prove at least a knowing and callous disregard for the rules).

Accordingly, the Court concludes that under the circumstances of this case, plaintiff may assert a cause of action for violation of the "know your customer" requirement of NYSE Rule 405, and the supervision and suitability requirements of that Rule and of Art. III §2 NASD and may prevail upon such a claim if he proves by a preponderance of the evidence that the actions of Stott and BEDCO constituted violations of the applicable rules "tantamount to fraud". To meet this standard in this case would mean that the violations operated as a fraud upon the plaintiff and that the defendants acted with *scienter,* that is, with intent to defraud or with willful and reckless disregard for the truth or falsity of their representations or of

whether there [sic] actions constituted a fraud. See *Lanza* v. *Drexel & Co., supra;* see also *Arthur Lipper Corp.* v. *SEC,, supra.*

The Court readily concludes that the actions of the three defendants operated as a fraud upon Dr. Rolf. Initially, the Court has found that Yamada's actions with respect to Delanair operated as a fraud upon the plaintiff. Further, the Court concludes that Yamada's handling of the Rolf account was generally of a fraudulent nature. Indeed, on the facts of this case, the Court has no doubt that the securities purchased by Yamada as a part of his manipulative schemes were unsuitable for the plaintiff. Finally, the complete transformation of the Rolf account from one containing 23 listed issues of reputable quality to an account made up of the likes of Hair Extension Centers, Health Evaluation Systems, and M. H. Studios evidences a breach by Yamada of his investment advisory duties which is doubtless "tantamount to fraud".

In such circumstances, where the plaintiff was being disserved by a faithless investment adviser, who was interested in his account only for its "buying power", the "hand-holding" operation successfully accomplished by Stott was, under the circumstances, a fraud upon the plaintiff.

First, Stott admitted that he never knew plaintiff's investment intent, and that he had no idea what type of investor this customer was when he recommended Yamada to Rolf. These admissions alone could suffice to form the basis of a violation of NYSE Rule 405(1) tantamount to fraud. Contrary to the clear requirements of that Rule, Stott totally failed to learn the essential facts relative to Rolf and

Rolf's account. Stott also failed to learn every essential fact relative to Yamada, since he did not learn whether Yamada would be a suitable adviser for Dr. Rolf.

Second, Stott's practice of continually voicing his confidence in Yamada and in Yamada's investment decisions constituted a fraud upon Dr. Rolf, who sincerely believed that Stott had some basis for his statements. The statements of support and the assurances which were repeatedly made were made with willful and reckless disregard for whether they were true or false. While Stott may have had a strong belief in Yamada's money-making abilities, he certainly knew, as the Court has concluded, that Yamada was continuing to invest plaintiff's money in "junk" even after plaintiff had lost three-quarters of a million dollars through such ventures. The evidence is clear that Stott never once recommended that Rolf reconsider any transaction. Stott never recommended against any investment. Stott never suggested to Rolf that perhaps Yamada was too speculative for the plaintiff's investment needs. Stott totally failed to perform the duties placed upon him, as a registered representative and as an employee of a member firm, to take adequate steps to protect the interests of a customer who had entrusted his securities account to BEDCO for six years. Accordingly, the Court concludes that Stott's actions were tantamount to fraud, since they deceived plaintiff into thinking that BEDCO was protecting his interests, and since they operated to help conceal from Rolf the fraud being perpetrated by Yamada.

For the same reasons, the Court concludes that plaintiff has proved by a preponderance of the evidence that Stott

acted with the requisite *scienter*. Stott recommended a number of issues for Rolf's account without ever knowing Rolf's investment intentions. He recommended Yamada without any knowledge about plaintiff's account. He continually held Dr. Rolf's hand and assured him, without any basis in fact, that Yamada's decisions were good for Rolf. The Court finds that these factors constitute a knowing, willful and reckless disregard for the truth, a callous and knowing disregard for the requirements of the NYSE and NASD rules involved herein, and proof of the *scienter* element by a fair preponderance of the credible evidence. This conclusion is based upon all the evidence in the case, as well as upon the Court's assessment of Stott's demeanor and credibility.

Even had Stott never assured the plaintiff with respect to Yamada, Stott's total failure to speak out nevertheless would suffice to render him liable for violations of the rules. Stott not only failed to learn about Rolf, but he totally failed to investigate the stocks in the account or to tell Rolf what he now claims—that he really didn't know anything about those stocks. If a broker acts only as an order-taker, he must not offer advice. If he begins to offer advice, he must not fail to make full disclosure. *Carrass* v. *Burns*, 516 F.2d 251, 258 (4th Cir. 1975). It is apparent that Stott "deliberately closed his eyes to facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant." *Dlugash* v. *SEC*, 373 F.2d 107, 109 (2d Cir. 1967).

A broker must not allow his silence to be taken as a recommendation. If he cannot or will not investigate the

security being purchased, he must disclose the fact to the customer and warn the customer of the risks of making investments without full knowledge of the issuer. He must satisfy himself that not only the security but also the type of transaction is suitable for the customer. See *Hanly* v. *SEC*, 415 F.2d 589, 597 (2d Cir. 1969); *Jacobs, supra* at 887-93. It is apparent that "securities issued by smaller companies of recent origin . . . require more thorough investigation." *Hanly, supra* at 597. Here, Stott testified that he never sent Yamada's speculative investments through BEDCO research to determine whether they were suitable.

For the foregoing reasons, the Court concludes that Stott is liable to the plaintiff in damages for violations of NYSE Rule 405 and Art. III §2 of the NASD Rules.

Aiding and Abetting

Plaintiff's complaint further asserts that Stott is liable to the plaintiff for aiding and abetting the fraud Yamada perpetrated upon the plaintiff. In order to sustain this claim, the plaintiff must prove that an independent wrong existed, that the alleged aider and abettor had knowledge of the wrong, that he acted with *scienter*, and that he rendered substantial assistance to the primary wrongdoer. *Lowenschuss* v. *Kane*, 520 F.2d 255, 268 n.10 (2d Cir. 1975); *SEC* v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974); *H. L. Federman & Co.* v. *Greenberg*, 405 F.Supp. 1332 (S.D.N.Y. 1975); *Rosen* v. *Dick* [1974-75] CCH Fed.Sec.L.Rep. ¶94,786 (S.D. N.Y. Sept. 3, 1974).

As the Court has observed above, the plaintiff has proven that Yamada defrauded the plaintiff through the Delanair transaction and that he breached his own fiduciary duties owed to the plaintiff by reason of his investment advisory agreement. These violations were not merely "tantamount to fraud" but rather, constituted a gross fraud. Thus, plaintiff has established an independent wrong by Yamada in violation of Rule 10b-5.

The Court has concluded that Stott knew of the nature of the securities which were being purchased in the account. Stott was aware that Yamada was purchasing highly unsuitable stocks, or "junk", even after such transactions had resulted in the loss of half of plaintiff's money. Even though Stott did not know of the direct frauds which Yamada was perpetrating on Rolf—such as Delanair—he must have known of the egregious violations by Yamada of the suitability rule. Accordingly, the Court concludes that plaintiff has established Stott's knowledge of the wrongful acts.

For the same reasons as detailed in the previous section, the Court concludes that Stott acted with *scienter;* that is, he made representations to the plaintiff with willful and reckless disregard for their truth, and he acted with a callous and knowing disregard for the requirements of the NYSE and NASD rules.

Finally, there can be little doubt that Stott afforded substantial assistance to the primary wrongdoer Yamada. By continually holding Rolf's hand and assuring him that Yamada's decisions were appropriate, Stott substantially diminished any opportunity for an earlier discovery by Rolf of Yamada's true intentions. By failing to recommend

against any venture and by failing to encourage Rolf to question Yamada's suitability as an adviser, Stott contributed to the perpetration of the depletion of Rolf's account and the accumulation of unsuitable securities therein. By trading the stocks through BEDCO with nary a thought as to their suitability or their legitimacy, Stott gave to Yamada what he needed: access to a large portfolio which could be used as a tool in his manipulations. Accordingly, the Court concludes that Stott is liable to the plaintiff for aiding and abetting Yamada's fraudulent violations of his own duties as an investment adviser.

BEDCO's Liability

Plaintiff further asserts that defendant BEDCO is liable for failure to supervise Stott and the Rolf account, either under the doctrine of respondeat superior or as a controlling person liable under Section 20 of the Exchange Act.

Four circuit courts have concluded that a brokerage firm may be liable to a defrauded customer under the common law principle of respondeat superior. See *Holloway* v. *Howerdd,* 536 F.2d 690 (6th Cir. 1976); *Fey* v. *Walston & Co.,* 493 F.2d 1036 (7th Cir. 1974); *Lewis* v. *Walston & Co.,* 487 F.2d 617 (5th Cir. 1973) (Wisdom, J.); *John* [sic] *Hopkins University* v. *Hutton,* 422 F.2d 1124 (4th Cir. 1970), *cert. denied,* 416 U.S. 916, 94 S.Ct. 1622, 40 L.Ed.2d 118 (1974). In this Circuit, two decisions have indicated a growing willingness to hold a brokerage firm liable, at least in enforcement actions, on the basis of the common law principle. See *SEC* v. *Geon Industries, Inc.,* 531 F.2d 39 (2d Cir. 1976) (Friendly, J.); *SEC* v. *Management Dynamics, Inc.,* 515 F.2d 801 (2d Cir. 1975) (Kaufman, C. J.).

Management Dynamics expressly disapproved of one district court decision which held respondeat superior inapplicable to a brokerage house, *SEC* v. *Lums, Inc.,* 365 F. Supp. 1046 (S.D.N.Y. 1973). See 515 F.2d at 811-13. Further, it has been suggested that certain language in *Geon Industries, supra,* signals the application of respondeat superior to brokerage firms in damages actions. See *Plunkett* v. *Dominick & Dominick, Inc., supra,* 414 F.Supp. at 899 (concluding that the common law principle applies).

On the basis of this discussion and the thrust of the cases, this Court concludes that defendant BEDCO is liable to plaintiff under the rule of respondeat superior. There can be no doubt that Stott's actions were within the course of his employment. See *Lewis* v. *Walston & Co., supra,* 487 F.2d 617 (5th Cir. 1973); Restatement of the Law of Agency (2d) §229; see also *Goodman* v. *H. Hentz & Co.,* 265 F.Supp. 440 (N.D.Ill. 1967).

The Court also finds BEDCO liable for failure to supervise the account, pursuant to Section 20 of the Exchange Act. The difference between respondeat superior and controlling person liability is "not entirely esoteric" since there is a good faith defense to the latter charge which is unavailable at common law. See *Plunkett* v. *Dominick & Dominick, supra.*

However, here BEDCO's compliance officer stated that all of the firm's control procedures to guard against churning and against unsuitability were jettisoned in the face of an investment adviser—any investment adviser. Under the decisions of the SEC in *In re William I. Hay,* 19 S.E.C. 397 (1945) and *In re Moore & Co.,* 32 S.E.C. 191 (1951), the Court concludes that BEDCO's system of supervision dur-

ing the time in question was wholly insufficient to guard against fraud by the investment adviser or by the broker who was trading for an investment adviser.

> "With considerable unanimity, the reported cases have required that to satisfy good faith it must be shown that the controlling person maintained and enforced a reasonable and proper system of supervision and internal control over controlled persons so as to prevent, so far as possible, violations of Section 10(b) and Rule 10b-5." (*Zweig* v. *Hearst Corp.*, 521 F.2d 1129, 1134-35 (9th Cir.), *cert. denied*, 423 U.S. 1025, 96 S.Ct. 469, 46 L.Ed.2d 399 (1975))

Although BEDCO did not have actual notice of the fraud, its acknowledged policy with respect to the firm's duties where an investment adviser is present, its complete failure to supervise any such accounts, and its laxness which went so far as to permit Stott to recommend an investment adviser with no knowledge of Dr. Rolf's account and even further to allow some *unidentified* person to trade in Rolf's account during April 1969, all lead the Court to the conclusion that BEDCO did not, during the period in question, establish even minimally sufficient safeguards to protect the investor from the type of fraud present in this case. Accordingly, the good faith defense has not been established. See *Barthe* v. *Rizzo*, 384 F.Supp. 1063 (S.D.N.Y. 1974).

Damages

Plaintiff has established that the acts of the defendants were a substantial or proximate cause of the placing of unsuitable securities in his BEDCO account. Stott's conduct

and BEDCO's failure to supervise created a continuous and active potential for harm to the plaintiff, see *Miller* v. *Schweickart*, 413 F.Supp. 1062 (S.D.N.Y. 1976), and it is clear that plaintiff was damaged as a proximate result of the defendants' fraud.

However, a persistent damages question in cases such as this one is whether the plaintiff can recover his net losses from the broker who failed in his duties. Having carefully considered the matter, the Court determines that the measure of damages for violation of the suitability and supervision rules should be the same as that applied by the federal courts in awarding damages for churning; i.e., the quasi-contractual theory whereby the defendants are directed to return to the plaintiff all commissions earned and interest paid. See *Hecht* v. *Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970); *Stevens* v. *Abbott Proctor & Paine*, 288 F.Supp. 836 (E.D.Va. 1968).

The Court concludes that it would be inappropriate to award the damages sought by the plaintiff—the net trading losses claimed. Although this measure has been granted by two state court decisions, *Twomey* v. *Mitchum, Jones & Templeton, Inc.*, 262 Cal.App. 690, 69 Cal.Rptr. 222 (1st Dist. 1968) and *Pierce* v. *Richard Ellis & Co.*, 62 Misc.2d 771, 310 N.Y.S.2d 266 (Civil Ct. N.Y. Cnty. 1970), the Court is unaware of any federal court which has ever applied this damage theory. Further, both *Twomey* and *Pierce* involved unsuitability *and* churning; only the former is present here. The *Pierce* decision has not been followed by the New York courts, see *Lehman* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, (Sup. Ct. N.Y. Cnty. Feb. 24, 1976), and this

Court finds itself in agreement with the criticism of the *Twomey* case set forth in *Stevens* v. *Abbott, Proctor & Paine, supra,* 288 F.Supp. 836, 849.

Since much of the damage suffered by the plaintiff here was as a result of poor investment decisions and as a result of a bear stock market (see DX-WW, DX-XX), it would be highly inappropriate to allow plaintiff to recover all his losses by assessing them against Stott and BEDCO. A much more logical measure of damages is to require the defendants to return all the benefit which they received, since they failed to give to plaintiff the consideration due him—supervision and diligence as to the account. Under the circumstances of this case, all other measures of damage are rejected as wholly speculative with respect to actual injury found by the Court to have been caused by the defendants' actions.

Plaintiff's complaint alleges that during the period in question, the defendants were paid by plaintiff commissions in the amount of $42,341.80 and interest on the margin account of $13,448.20. These figures were mentioned by the various witnesses at trial, and the sums are compiled from BEDCO statements (PX-12, PX-13, PX-14). The Court considers an award of commissions and margin account interest to be proper in this case, since it restores to the plaintiff all monies paid to the defendants Stott and BEDCO during the period in question.

Plaintiff also makes a post-trial claim for punitive damages, but the Court declines under the circumstances to grant such an application. First, there is no dispute that plaintiff's complaint set forth no cause of action under state

law; despite the decisions cited by the plaintiff, see *Henry* v. *United States,* 424 F.2d 677 (5th Cir. 1970), the Court would not be willing to grant an application to amend the pleadings at this late date. In any event, the point is academic since the Court does not find that an award of exemplary damages should be granted in this case.

First, there is substantial doubt as to whether a plaintiff can ever receive punitive damages for violations of federal securities laws. See *Green* v. *Wolf Corp.,* 406 F.2d 291 (2d Cir. 1968), *cert. denied,* 395 U.S. 977, 89 S.Ct. 2131, 23 L.Ed.2d 766 (1969); *Myzel* v. *Fields,* 386 F.2d 718 (8th Cir. 1967), *cert. denied,* 390 U.S. 951, 88 S.Ct. 1043, 19 L.Ed.2d 1143 (1968). Even assuming that there was no procedural or statutory obstacle to the grant of punitive damages, the Court would not make such an award based upon the rationale stated by the Court in *Stevens* v. *Abbott, Proctor & Paine, supra*:

> "The Court finds that the conduct engaged in in the instant case results from the failure of the defendants to abide by their legal responsibilities, but finds no reason to believe that by awarding exemplary or punitive damages, actions in the future similar to those which give rise to the instant suit would be any more deterred than by virtue of the fact that the suit itself has accomplished that very result." (288 F.Supp. 836, 848)

Accordingly, plaintiff shall recover commissions and interests paid on the margin account, plus interest from the date of the entry of judgment herein. See *Stevens* v. *Abbott, Proctor & Paine, supra.*

Appendix C

The Cross-Claims Against Yamada

The Court concludes that a broker and his employer should not be permitted to receive indemnity from the customer's investment adviser where the broker and his firm have failed in their duty to protect the interests of the customer, in violation of NYSE and NASD rules and in violation of Rule 10b-5. To allow indemnity in this case would be to encourage flouting the policy of the securities laws. See *Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913, 90 S.Ct. 913, 25 L.Ed.2d 93 (1970). Accordingly, the cross-claims against Yamada are dismissed.

Conclusion

Judgment should be entered for the plaintiff David E. Rolf against defendants Blyth Eastman Dillon & Co., Inc., and Michael Stott for damages in the amount of $55,790.00 plus interest from the date of judgment, in accordance with the decision of the Court herein. Judgment should further be entered dismissing plaintiff's claims against the defendant Akiyoshi Yamada in accordance with the stipulation and order entered at the conclusion of trial, and dismissing the cross-claims of defendants BEDCO and Stott against Yamada. Counsel for the plaintiff is directed to submit an appropriate order of judgment on three days' notice.

SO ORDERED.

APPENDIX D

Order of the United States Court of Appeals for the Second Circuit Denying Rehearing

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the third day of July, one thousand nine hundred and seventy-eight.

Present:

Hon. J. JOSEPH SMITH,
Hon. WALTER R. MANSFIELD,
Hon. JAMES L. OAKES,
Circuit Judges.

Docket No. 77-7104

DAVID E. ROLF,
Plaintiff-Appellant-Appellee,

v.

BLYTH EASTMAN DILLON & CO., INC.,
AKIYOSHI YAMADA and MICHAEL STOTT,
Defendants-Appellees-Appellants.

A petition for a rehearing having been filed herein by counsel for the defendants-appellees-appellants, Blyth Eastman Dillon & Co., Inc.,

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

[SEAL]
United States Court of Appeals
FILED
JUL 3 1978
A. DANIEL FUSARO, Clerk
SECOND CIRCUIT

A. DANIEL FUSARO,
Clerk

APPENDIX E

Order of the United States Court of Appeals for the Second Circuit Denying Rehearing in Banc

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the third day of July, one thousand nine hundred and seventy-eight.

Docket No. 77-7104

DAVID E. ROLF,
Plaintiff-Appellant-Appellee,

v.

BLYTH EASTMAN DILLON & CO., INC.,
AKIYOSHI YAMADA and MICHAEL STOTT,
Defendants-Appellees-Appellants.

A petition for rehearing containing a suggestion that the action be reheard en banc having been filed herein by counsel for the defendants-appellees-appellants, Blyth Eastman Dillon & Co., Inc., and Michael Stott, a poll of the judges in regular active judges having been taken and there being no majority in favor thereof,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

Judges Mansfield, Mulligan, Gurfein and VanGraafeiland dissent in the denial.

/s/ IRVING R. KAUFMAN

IRVING R. KAUFMAN, Chief Judge

[SEAL]
United States Court of Appeals
FILED
JUL 3 1978
A. DANIEL FUSARO, Clerk
SECOND CIRCUIT

APPENDIX F

Statute and Rule Involved

Section 10(b), 15 U.S.C. §78j(b):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. §240.106-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.